THE MILKEN INSTITUTE
Review
THIRD QUARTER 1999
A JOURNAL OF ECONOMIC POLICY

Back to School Issue

TOM KANE on Financing Higher Education

ROGER NOLL on the Economics of College Sports

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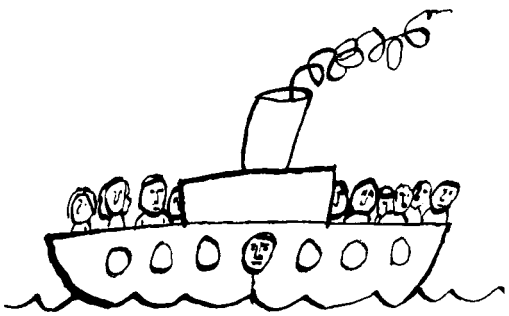

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EDITOR'S NOTE

We're fit, we're rested – and we're back with the third issue of *The Milken Institute Review*. This is the magazine about economic policy that may occasionally get it wrong – more than a few readers wondered whether our cover story on who lost Brazil was a wee bit premature – but will never fail to be provocative.

And this time around, the provocations range from a very tough look at American immigration policy to an even tougher look at the American college-sports cartel, also known as the N.C.A.A.

Stephen-Götz Richter, the head of TransAtlantic Futures, asks Europeans to stop worrying and learn to love the cheap euro. Euroland, Richter explains, needs a depreciated currency to sustain demand for its products while the continent goes about the long-overdue process of deregulating markets and revamping slothful industries. "The restructuring horse is truly out of the European barn, and will not be put back," he writes; "anything and everything possible must be done to help the wide European polity learn to live with, and even love, American-style capitalism."

Uwe Parpart, a Bangkok-based columnist for *Forbes Global* magazine, offers a report from the trenches on the East Asian recovery. And he hardly comes off as a Pollyanna. "Even in the boom years of the early 1990's, battles over market share or political rows over wealth distribution in East Asia were never pretty," he writes. "But now that the very existence of businesses is at issue, things have gotten really nasty."

Strikingly, though, Parpart's bottom line is optimistic. "Betting on East Asia's middle class," he cautiously allows, "is looking like a good wager."

Bill Gale of The Brookings Institution and **John Sabelhaus** of the Congressional Budget Office set out to go where many economists have gone before. But unlike the others, they really have managed to unearth everything you wanted to know about America's savings "crisis" and maybe a bit more.

The saving rate, we all know, has plunged precipitously in the last few decades. What we didn't know is that the official numbers offer little insight into the key questions – whether the baby boomers are failing to prepare for retirement or whether America has become dangerously dependent on foreign capital. And happily, things don't look bad. Adjusting for inflation and capital gains, they conclude that "rates of real wealth accumulation in the late 1990s are higher than at any time in 40 years."

Tom Kane, an economist at Harvard's Kennedy School of Government, made a splash some years back for his brave and lucid analysis showing that ending affirmative action would drastically reduce minority enrollment at elite colleges. Here, he takes on a less explosive but equally important topic in higher education: access for students from low-income families.

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"My proposals," he writes, "are aimed at increasing the bang from a Government buck, retargeting existing subsidies to encourage students to experiment with college and to pool the risk in choosing to enter college."

Roger Noll, an economist specializing in regulatory issues at Stanford, has always been a thorn in the side of the Pooh-Bahs who run the business of sports in America. His critique of Major League Baseball's claim of poverty, made in defense of the players' union, was devastating. Here, he lays out the peculiar economics of intercollegiate sports and the even more peculiar consequences of its cartelization by the National Collegiate Athletic Association.

Noll defends colleges' enormous investment in sports as a matter of good marketing: "Universities have comprehensive varsity athletics programs largely because many students want to be intercollegiate athletes." But he adds that "the N.C.A.A.'s behavior indicates that it is mostly interested in suppressing payments to athletes in a way that benefits coaches and the athletes who play minor sports."

George Borjas, yet another scholar at Harvard's Kennedy School, is a veteran at making both liberals and conservatives angry. For the Cuban-born, Chicago-educated economist has spent much of his academic career analyzing America's immigration policy – and finding it long on noble sentiment and short on economic sense. In particular, he is critical of the focus on reuniting families at the expense of skills-based tests.

This excerpt from his new book, from the Princeton University Press, doesn't go very far to rehabilitate his politically incorrect image. But his words are worth a close read. "I believe that immigration policy should be set in ways that further the national interest," he writes, "and this may simply not coincide with giving a particular person or ethnic group the opportunities America offers."

Those who read *The Milken Institute Review* with some care – yes, it has been known to happen – will note that the book reviews are getting longer. This is not due to some carefully considered editorial policy. I just happened to commission a pair of reviews for this issue that came in long and deserved the space.

Martin Mayer, a guest scholar at The Brookings Institution with a long list of smart, accessible books about financial markets to his credit, reviews Jean Strouse's biography of J.P. Morgan. And along with assessing the great financier and his distinguished biographer, Mayer adds a scholarly footnote on Morgan's interest in the opera. On reflection, that's not surprising: Among his many accomplishments, Mayer is a professional music critic.

From the sublime to the mundane. Well, not exactly mundane. **David Henderson**, an economist at The Hoover Institution, takes a look at what might be called "home economics" if that hadn't come to mean cooking, cleaning and finding bargains at Kmart. His review, of Dwight Lee and Richard McKenzie's book on how to get rich slowly, offers uncommon sense about a topic that economists generally ignore – but that the vast majority of Americans consider far more important than the elasticity of demand for widgets or the current account deficit of Brazil.

We skipped the puzzler in this issue. But we do offer some equally worthy distractions: the sayings of Chairman Summers, the looming role of high-tech in regional growth, news from The Milken Institute and of, course, Mark Alan Stamaty's Ekinomix.

And hey, I'm lonely. Don't forget to write (ppassell@milken-inst.org).

— Peter Passell

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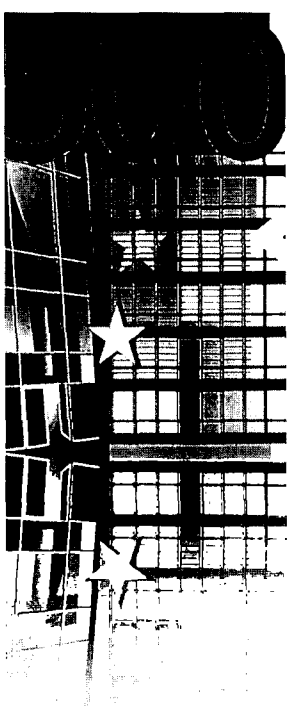
BY STEPHAN-GÖTZ RICHTER

Many European economists are adamantly warning against a weak euro, even though currency movements of the magnitude of the euro's recent fall – roughly 15 percent against the dollar – are quite common. Moreover, from a purely economic perspective, the euro's decline is more than understandable: Short-term interest rates are higher in the United States, acting as a magnet for idle corporate cash for payrolls, inventory and the like.

To quite a few Europeans, though, the euro represents something besides a currency. They view it as the means by which Europe can wrest its rightful position as co-leader of the global economy. And thus, to them, the euro's decline so soon after its creation amounts to failure.

But seen in proper context, the euro's weakness is an opportunity. Europe needs a weak euro to foster industrial restructuring, and the unified currency could promote this process with less muss and fuss. Imagine, by contrast, the hoopla and backbiting we would have seen by now had a whole range of European currencies moved lower – probably to uneven levels and at uncertain rates.



RON CHAPPLE/FPG INTERNATIONAL (2)

STEPHAN-GÖTZ RICHTER is the president of TransAtlantic Futures, a Washington-based economic intelligence group.

HOW TO PROMOTE RESTRUCTURING

From the perspective of the United States, it is vital to understand how the euro's decline is a key to a European economic renaissance. Europe faces a difficult task in the next few years, restructuring businesses so they can attain the productivity of American competitors. Fortunately, the Europeans have a model for this process – namely what happened in the United States about 15 years ago.

Back then, American businesses underwent a restructuring similar to what Europe needs today. And by the late 1980's they had a powerful, if impersonal, ally in their efforts to become more competitive: the weak dollar. Between early 1985 and late 1989 the dollar's exchange rate against major currencies fell by about one-half. Despite the relatively small

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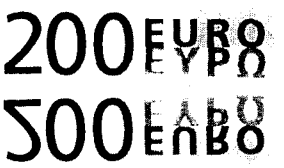
weight of trade in the United States economy – coincidentally, about the same as the weight of overseas trade in today's Euroland – the dollar's depreciation provided the extra kick in demand needed to keep the United States economy growing. Jack Welch, chairman of the General Electric Company, made no bones about cause and effect. "We're pounding ourselves on the chest in America over how wonderfully we've done," he explained. "But we got a huge help from the currency."



The traditional European economic argument against current depreciation is linked to concerns about inflation. Depreciation makes imports more expensive and increases demand (foreign and domestic) for domestically made goods – and is thus doubly inflationary. Moreover, in the past Germans especially wanted a strong currency to stop inflation at the border.

But in today's low inflation (some would say deflationary) environment, such concerns are overblown. And compared to the advantages of allowing the euro to weaken, the inflation argument should carry little weight. Consider that exports accounted for about 13 percent of Euroland GDP in 1997. A 5 percent increase in exports – a reasonable assumption given even a modest euro depreciation – would thus raise Euroland's GDP by 0.6 percentage points, a substantial portion of one year's growth. Depreciation would have an even larger impact since it would make European manufacturers more competitive domestically as well. Americans used similar gains to ease the dislocation associated with restructuring in the late 1980's, and with little impact on prices.

THE POLITICS OF MONEY AND RESTRUCTURING

The nexus between economics and politics in Europe has moved a long way over the past year. The defeat of old-style Euro-socialism, embodied in the resignation of Oskar Lafontaine in Germany, opens a window of opportunity for the forces of reform. Now is the best time to enhance and direct the restructuring of European business. And the European Central Bank is the institution that could pull it off.

At its birth, the E.C.B. found itself facing a dilemma. As every green-eyeshade type knows, financial markets' conviction that the central bank will support the value of the currency is the key to central banking success. By the same token, however, the European economy was badly in need of a dose of easy credit to take it out of the doldrums.

The E.C.B. faces another credibility issue, however – one which has broader implications for Euroland. Should the role of the central bank be narrowly defined as an agent of monetary policy, or should it take broader responsibility for the heath of the European economy? As the German Bundesbank has shown in the past, a central bank can lead the way in developing a society's economic strategy.

The Bundesbank's reputation was made not only by maintaining a strict monetary policy, but by serving as a stabilizing influence on economic policy even as the politicians

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dithered. If the E.C.B. is to be more than a minor institution – if it is to become for Europe what the Bundesbank has been for Germany – then it will need to take an active role in meeting Europe's prime challenge: the restructuring of its corporate sector.

The potential political fallout is enormous. Workers are about to discover that, despite decades of loyalty to employers, their services are no longer valued. Communities will discover there is no such thing as a good "corporate citizen" – that business is in the business of making money, period. And just as happened in the United States, workers, communities (and in Europe, whole countries) affected by restructuring will no doubt try to slow it down or lead it down inefficient paths.

AN INDUSTRIAL-MONETARY PACT

In the United States, the dollar's fall undermined these forces of resistance. Simply put, layoffs and corporate changes are much easier to accept when new opportunities abound. There is a catch, however: If European governments use a weak euro to protect inefficient companies from foreign competition, it would be worse than useless. What Euroland thus needs is a kind of industrial-monetary pact, one combining currency depreciation with structural reform.

As European businesses pursue the process of rationalizing their operations, the E.C.B. and the national governments could put in place the policies to minimize the suffering. The E.C.B.'s role, then, would be to maintain relatively easy credit, and thus allow the euro to weaken. The weak currency would help to keep the economy buoyant, reducing the pain for individuals and communities. This would, in turn, help to insulate the restructuring from political interference.

For their part, European governments – especially Germany, France and Italy – would adopt the legal, regulatory and labor-market reforms to facilitate the restructuring. By creating this implicit "conditionality" in its monetary policy, much the way the I.M.F. conditions loans on structural changes, the E.C.B. could smooth the way to American-style competition.

An industrial-monetary pact would also help the E.C.B. to accomplish the single most important task it faces in its formative years. To become an effective institution, the E.C.B. must carve out its own expertise and power, separate from those of the national central banks. Otherwise, the E.C.B. will remain vulnerable to the kind of confusion that reigned when national central bank heads – notably Hans Tietmeyer – have insisted on maintaining strong, independent voices that undermine the E.C.B.'s message. An E.C.B. initiative on an issue of great importance would be the ideal way to establish it as the continent's premier economic policy-making body.

Constructing such a pact would obviously require political effort, but the potential payoff is worth it. A monetary-industrial deal would satisfy both those Europeans who want to see the continent recognized as an economic powerhouse and those who want a weak currency to stoke demand. Easy money types calling for a weaker euro would get it, but only under conditions insuring that the depreciation translated into permanent structural improvement.

THE ROLE OF THE UNITED STATES

The exchange rate issue requires leadership, and not only from the E.C.B. Making room for European restructuring requires foresight on the part of the United States. Indeed, it would be a test of whether America is fit to play leader in the world economy – a test that requires the country to rise above its inclina-

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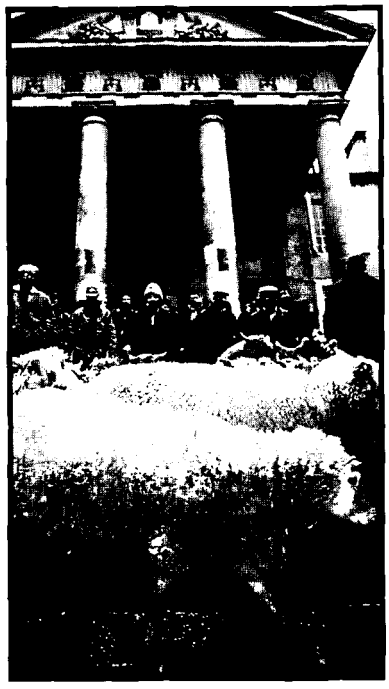
tion to see itself as the victim of ungrateful foreigners. Leadership demands not merely the passive example of its economic structure, but the active acceptance of the responsibility that comes with being the trailblazer.

Dollar appreciation is consistent with two points that American leaders – notably Treasury Secretary Larry Summers – have articulated with regard to Europe. First, they strongly advocate that Europeans reduce their emphasis on macroeconomic management and pay more attention to the restructuring of inefficient, overregulated markets. Second, they realize that businesses compete, not economies – that the U. S. has much to gain and little to lose from a more productive European economy.



A cheaper euro means happier farmers.

THOMAS HALEY/SIPA PRESS

The restructuring horse is truly out of the European barn, and will not be put back. Global capital markets are forcing European companies to rationalize or risk being crushed. The threat is not just from more efficient foreign producers, but also from global investors who seek other, more profitable places to put their money.

The big headline mergers – along with less obvious changes in financial and managerial behavior – are bringing corporate Europe into a new era. And the fallout is beginning to show up on the political radar. Overcoming resistance is a matter for the Europeans themselves. As noted earlier, however, a weaker euro would help grease the wheels, and it is here that Summers could make a difference. For, by virtue of his management powers over the dollar, the Treasury Secretary can help insure that it is directed along the path the United States chose in the 1980's.

Summers' second point – that competition between economies is a mirage – underscores a vital educational mission. Many Americans view the global economy as a zero-sum game in which the United States loses when foreign economies grow. For his part, Summers has clearly stated that "to the extent that Europe is more prosperous and confident, it will be a better partner for us." But it is important not just for him to understand, but also to lead the United States to the same understanding. Summers should be unequivocal in asserting that the result of a weak euro (in tandem with a determined effort to restructure) will be a stronger European economy. And that both continents will benefit.

Europe's moves in this direction amount to the sincerest form of flattery. Europeans, who have long criticized the uncontrolled capitalism of the United States, have discovered it is precisely this lack of control that encourages risk-taking and economic growth. Corporate Europe is committed to the new order. But others will certainly become unhappy, as the implications become widely understood. Everything possible must be done to help the wide European polity learn to live with, and even love, American-style capitalism.

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Returning by popular demand,* we once again offer capsule reviews of selected published articles and unpublished working papers relevant to economic policy. By the way, suggestions for research to include in future columns are always welcome.

CAR WARS

Back in 1973, General Motors was king and the occasional Honda subcompact seen puttering down the highway was driven by a hippie or a college professor. A quarter century later, Japanese cars have become the common-sense vehicles of choice, praised or damned as instruments of Detroit's fall from grace.

But what really explains the dramatic shift in market share? Conventional wisdom says the Japanese offered the right models at the right time – small, fuel-efficient vehicles for an oil-scarce world – and then won brand loyalty with exceptional reliability. Brad Barber and Masako Darrough of the University of California-Davis, along with Reid Click of George Washington University, offer a more textured analysis.

Oil price changes did make a difference, they confirm, but explain only 6 percent of the month-to-month changes in market share. Likewise, exchange rates and the business cycle mattered. But such macroeconomic effects explain less than 20 percent of variations in sales. It seems that the Japanese sold product the old-fashioned way, making the cars people wanted at prices they were willing to pay.

By the same token, Detroit's comeback can largely be explained by producing sport utility vehicles early and often. All told, this is a reassuring lesson in market economics. [*"The Impact of Shocks to Exchange Rates and Oil Prices on U.S. Sales of American and Japanese Automakers." Japan and the World Economy. Volume 11, 1999. For access, e-mail the authors: rclick@gwis2.circ.gwu. edu.*]

WHAT IS TO BE DONE?

Six times in the 1990's, reminds Martin Mayer of The Brookings Institution, crises have shaken the world's financial structure. And each time the response of policy makers has been to go looking for "a new financial architecture."

Mayer, an expert in banking who has always come at the issues from the perspective of a practical man, is deeply skeptical that the ritual is useful. "Our discussions of financial matters have moved too far from the realities of getting and spending in real economies," he writes in a working paper for the Jerome Levy Economics Institute. "Once perceived as parasitical but inescapable in a world where only partial information exists,

Thank you, Rodney Popular of Managua, Nicaragua

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trading in financial instruments has become the one and only yellow brick road to price discovery."

Big changes designed to buttress the weakened walls of global finance are not particularly likely to work, he suggests. And besides, they barely have a prayer of being implemented. Mayer points to the rise of financial derivatives as a prime source of the instability problem. But he's hardly optimistic that this genie can be put back in the bottle. The bottom line to this insightful, elegantly crafted essay: A variety of modest but practical measures could minimize the damage from crises. [*"Risk Reduction in the New Financial Architecture: Realities, Fallacies and Proposals," Jerome Levy Economics Institute Working Paper 268. Download free from www.levy.org.*]

MAKE MINE A DOUBLE

It is common knowledge that post-Soviet Russia has evolved into a hollowed-out Sparta, a warrior state with a great nuclear arsenal that is nonetheless unable to feed its pensioners. But there is still plenty of shock value in reports of how low the Evil Empire has fallen since Boris Yeltsin rallied democrats from the top of a tank.

Nicholas Eberstadt of the American Enterprise Institute offers the latest bad news on the state of Russians' health. In 1998, he reports, death rates were a whopping 30 percent higher than they were a decade earlier. Indeed, deaths in Russia are now exceeding births by an astounding 700,000 a year. And life expectancy is lower than in such earthly paradises as Mauritius, Ecuador and Azerbaijan.

But why? Eberstadt dismisses two fashionable explanations, ecological degradation and infectious disease. Both are serious problems, but neither can account for more than a tiny fraction of the rise in mortality. The big death categories for men are cardiovascular disease and accidental injury, which may be indirectly linked to Russia's astounding rate of alcohol abuse. Some 80 percent of Russian men drink, consuming an average of four bottles of vodka a week!

Eberstadt suggests that

Pssst.... Wanna Buy Stocks Cheap?

In recent years, market analysts have been scrambling to explain the run-up in stock prices in the 1990's. The result has been the very public abandonment of old-fashioned Fundamentalist principles of valuation, along with a lot of hand-waving – pompous pronouncements about the New Economy and self-congratulation about the virtues of American economic institutions.

Charles Lee (Cornell), James Myers (University of Washington) and Bhaskarian Swaminathian (Cornell) come at the question somewhat differently. They assume that intrinsic value is a predictor of stock prices, but operates in a "noisy" environment. The goal, then, is to create a better measure of intrinsic value that will tend to converge with market price. Cutting to the chase, their empirical measure of value depends more on short-term interest rates and less on other factors than has been traditionally assumed. [*"What is the Intrinsic Value of the Dow?" Journal of Finance, forthcoming October. 1999. Download from www.cob.ohio-state.edu/~fin/journal/abstract.htm.*]

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the health crisis has literally undermined the ability of Russia to play geopolitics on the old model. I'm not so sure. But convincing or not, this piece from the conservative Heritage Foundation's journal is provocative reading. [*"Russia: Too Sick to Matter?" Policy Review, June/July 1999. Download free from www.policyreview.com.*]

WITH A LITTLE HELP FROM THEIR FRIENDS

It's easier to play catch-up in the global economy than to be the leader. Growth rates in the early stages of modernization in Russia, China, Korea, Indonesia and other nations with similar economies have often exceeded 6 percent – probably twice the sustainable rate in mature industrial economies.

One reason for the difference is that followers can borrow the technology of the leaders. As America discovered in the early 19th century, it is far cheaper to buy (or steal) innovations than to develop them in the first place.

That said, it is still difficult to pin down the role of technology transfer on growth. Tamim Bayoumi and David Coe of the International Monetary Fund, along with Elhanan Helpman of Tel Aviv University, give it the old college try, using a simulation model built by the I.M.F. If, for example, the United States were to raise R&D expenditures by one half of 1 percent of GDP and maintain that higher level, they predict that output in the United States would be 9 percent greater after 80 years, while output in the rest of the world would be 3 percent greater. If all the developed countries increased research and development outlays by the same half of 1 percent, emerging-market economies would rise by 10 percent.

There are a couple of important caveats. First, a lot of the spillover effect from innovator to copier depends on higher levels of investment induced by new technology – investment that is only possible if savings rates are high in emerging economies. Second, international trade still greases the

Measuring the Intangible

Dogs love trucks and economists love markets. Well, most of the time. Environmental economists are perpetually plagued by the problem of valuing intangible goods that lack markets – really important stuff such as human health or the survival of animal species. In most cases, common sense seems to dictate all-or-nothing answers, as in "No amount of money can compensate for the death of a child," or "Who needs the snail darter, anyway?"

This working paper by Dallas Burtraw and Alan Krupnick of Resources for the Future is nominally a study of the benefits associated with cleaning up America's Great Lakes. But it will also interest those who aren't sure whether Cleveland is on Lake Erie or Lake Michigan. For it includes a terrific non-technical discussion of measuring environmental costs and benefits in the context of a very practical issue. And it offers hope that there really is a happy middle between breathless environmentalism and bloodless economics. [*"Measuring the Value of Health Improvements from Great Lakes Cleanup," Resources for the Future Discussion Paper 99-34. Download free from www.rff.org/air.htm.*]

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If China Makes It, Will They Buy It?

As the west tries to coax China into the club of civil societies, it has precious few carrots to offer. The vegetable du jour, of course, is membership in the World Trade Organization, which would give China automatic access to foreign markets.

But what, really, would be the economic impact of membership on China? Zhi Wang, an economist with the U.S. Department of Agriculture's Economic Research Services, simulates changes in China's trade patterns as well as those of its competitors and trade partners if it were a member of the W.T.O.

The monster in the box is textiles and apparel. China offers vast amounts of low-cost labor, as well as the organizational skills to transform that labor into exportable goods. If China joins the W.T.O., Zhi Wang estimates that it will benefit from the gradual elimination of quotas negotiated in the Uruguay Round trade deal, increasing its share of total world textile exports from 18 percent to about 25 percent. And this gain, he reckons, would largely be at the expense of other low-wage Asian countries.

This raises a couple of interesting issues. Will the fight for the global market for labor-intensive goods generate serious political conflict between China and rivals such as Pakistan, India and Mexico? And will the rich countries be willing to absorb the vast tide of labor-intensive exports needed for these populous nations to pull themselves up by their bootstraps? Stay tuned. [*"The Impact of China's W.T.O. Entry," The World Economy, May 1999.*]

wheels of progress; without trade, the spillover effects from technology are modest. [*"R&D Spillovers and Global Growth," Journal of International Economics, April 1999. For access, download from www.elsevier.com/locate/econbase or e-mail the authors: dcoe@imf.org.*]

TRADE TRIUMPHANT

In the wake of the collapse of planned economies and the triumph of American-style capitalism, the Left has been regrouping. And one of the more interesting propositions of western-educated economists of the Left – notably Dani Rodrik at Harvard – is that the celebrated relationship between trade and growth is a statistical misunderstanding. There's more at stake here than a few academic reputations. If open trade is not critical to growth, there is no compelling need to press developing countries to open their borders or to take their chances in an unstable global trading system.

Jeffrey Frankel at Harvard's Kennedy School, along with David Romer of the University of California (Berkeley), aren't buying this newest revisionism. They use a neat – and entirely valid – statistical trick to distinguish cause and effect in the trade-growth nexus. And happily for those of us who have never had much use for sunspots, the causal relationship works in the "right" direction: with other factors being equal, a 2 percent increase in the ratio of trade to GDP increases income per person by 1 percent.

[*"Does Trade Cause Growth?" American Economic Review, June 1999.*] M

— Peter Passell

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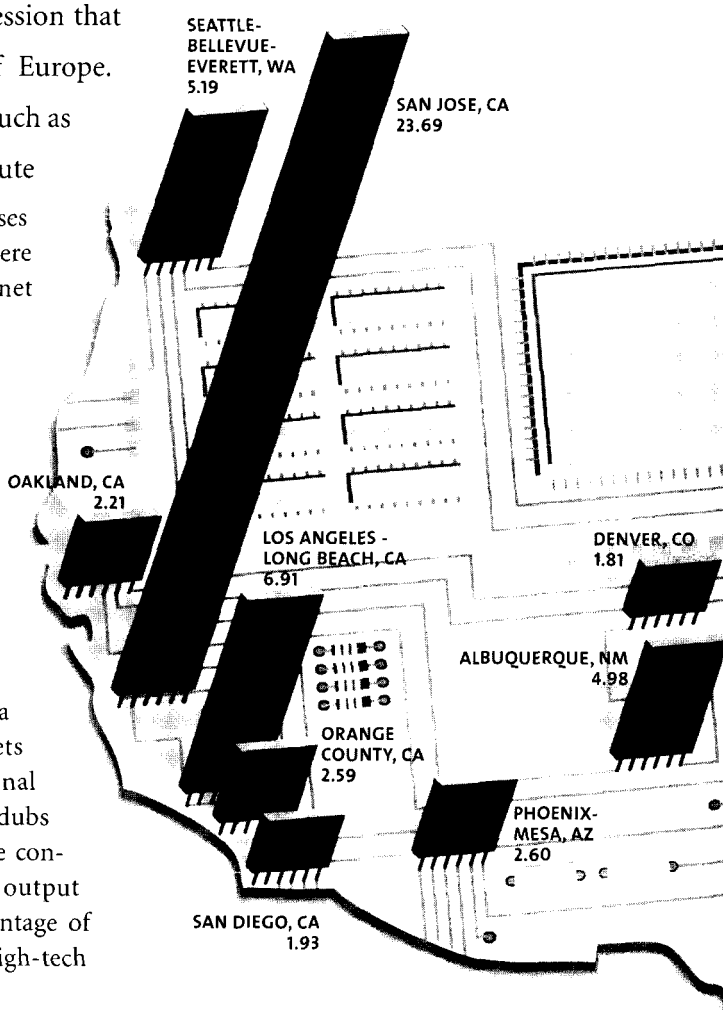
There's a good case to be made these days that high technology is bringing home America's bacon, powering the productivity boom and sparing the nation from the recession that has dogged Asia and much of Europe. This makes high-tech clusters – such as Silicon Valley and Boston's Route 128 – that attract high-tech businesses even more important than they were thought to be before the Internet became The Next Big Thing.

Which clusters really matter to the economy's future? The concentration of high-tech output in a metropolitan region (i.e., the percentage of a metro region's output that is attributed to high-tech goods and services) can be a misleading measure. America is full of towns in which half the population works for just one or two high-tech companies. To build a better index of high-tech magnets (Ross DeVol, director of Regional Studies at the Milken Institute, dubs them "tech poles"), we weighted the concentration of high-technology output figures by the metro region's percentage of the overall national output of high-tech goods and services.

Silicon Valley (San Jose, Calif.), no surprise, is the index leader with a whopping score of 23.7. Here, though, are a bunch of surprises: Dallas (7.1), Los Angeles (6.9), Washington, D.C. (5.1) and Chicago (3.8).



For more on the subject of high-tech clusters, check DeVol's article on page 90, or his Policy Brief, just published by The Milken Institute (www.milken-inst.org).

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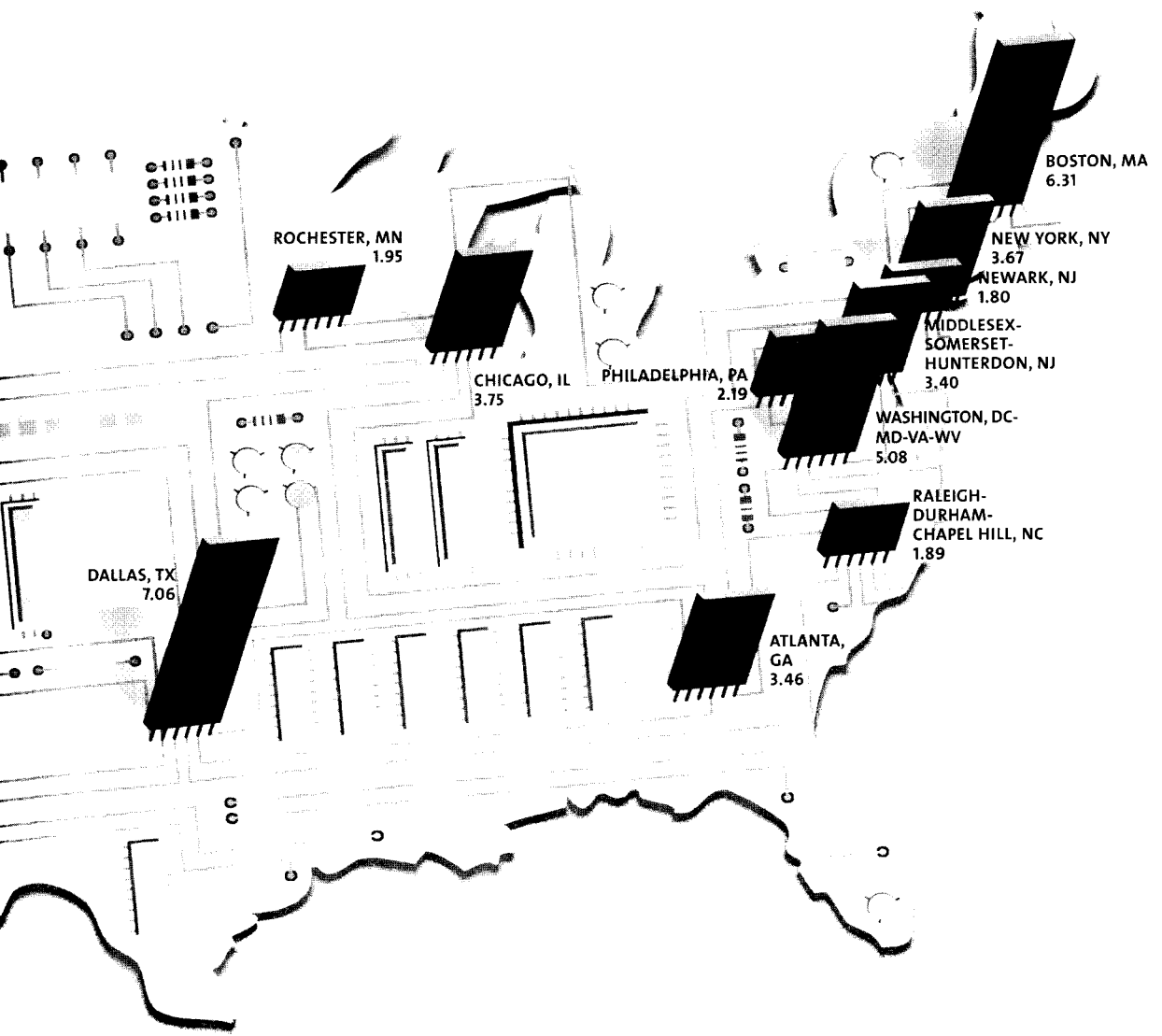
Where the Techies Stack Their Chips
(An index of Technology Concentration)

See page 90



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RETHINKING THE WAY AMERICANS PAY FOR COLLEGE

More bang for a buck

By Thomas J. Kane

The stakes have never been higher in the decision about who goes to college and who doesn't. In 1980, the typical young male college graduate starting a career earned just 20 percent more than his counterpart who went to work right out of high school. By 1995, that difference had widened to 52 percent – more than doubling the earnings premium for college graduates. Even a few years of college makes for big differences in paychecks.

As an increasing proportion of high school graduates are responding to the ever more obvious incentives to go to college, the system for financing higher education is showing signs of strain. Even after accounting for inflation, tuition within each category of college – public or private, two-year or four-year – rose by more than 110 percent between the 1980 and 1998.

The ultimate goal: increasing the social mobility of America's young and poor.

Politicians have been far ahead of policy wonks in recognizing parents' growing anxiety about how they are going to pay these tuition bills. Polling data persuaded President Clinton to make the Hope Scholarship college tax credit a centerpiece of his 1996 campaign. Not to be outdone, Congressional

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STEPHEN WEBSTER/PHOTONICA

Republicans overcame their anti-regulatory fervor long enough to appoint a Federal commission to contemplate steps for curbing tuition inflation.

However, the debate has been longer on rhetoric than on ideas for making college affordable for all. The two fundamental components of the nation's financial aid systems – massive state subsidies for public institutions and Federal subsidies distributed according to student need – have remained largely unchanged since the mid-1970's. Indeed, last year's politically charged debate over the Higher Education Act yielded nothing more dramatic than some tinkering with the interest rates charged on Federal loans to students.

WHY RETHINK FINANCIAL AID?

Any sort of education, elementary to graduate school, is "labor intensive," making it both

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costly to produce and resistant to the sorts of productivity gains that have revolutionized many industries in recent decades. Yet concern about the cost of education intrudes on the public consciousness only occasionally since the nine out of ten parents who send their children to public grade schools do not write a check for education until their kids are ready to attend college.

Many parents, no doubt, would be surprised to learn that the average annual expenditure per student in public elementary and secondary schools in 1995 was $6,213. This may seem an impossibly large number until one looks closely at where the money goes. In 1995, there were 17.1 students in attendance per full-time-equivalent teacher. With teaching salaries averaging $37,846, plus another 27 percent in benefits, instructional costs alone run to $2,788 per student a year. Add $549 per student for building operation and maintenance, $221 for transportation, $225 for food services, $252 for health services, $446 for administration, $212 for instructional support (libraries, computer labs, etc.) – and you begin to see why education is a big nut to crack for both state and local budgeters alike.

TABLE 1: DIFFERENCES IN POST-SECONDARY TRAINING FOR THE HIGH SCHOOL CLASS OF 1992
BY PARENTAL INCOME QUARTILE

	OTHER VARIABLES HELD CONSTANT			
PARENTAL INCOME QUARTILE	NONE	MATH & READING TEST SCORES, HIGH SCHOOL GRADES	... AND 8TH GRADE SCHOOL	... AND PAREN EDUCATION
PERCENTAGE POINT DIFFERENCE IN PROPORTION OF YOUTH ENTERING ANY POST-SECONDARY TRAINING WITHIN 20 MONTHS OF HIGH SCHOOL GRADUATION, COMPARED TO YOUTH FROM THE BOTTOM QUARTILE				
Top	28	18	14	10
Second	22	15	14	11
Third	11	7	6	5
PERCENTAGE POINT DIFFERENCE IN PROPORTION OF YOUTH ENTERING A FOUR-YEAR COLLEGE WITHIN 20 MONTHS OF LEAVING HIGH SCHOOL, COMPARED TO YOUTH FROM THE BOTTOM QUARTILE				
Top	36	18	12	6
Second	20	8	7	3
Third	9	2	1	1

The surprise hardly ends there. In the 1998-99 academic year, annual tuition averaged $1,600 at two-year public colleges and $3,200 at four-year public colleges. This is far less than the average expenditure per student, which runs roughly $6,000 at the two-year publics and $11,000 at the four-year variety.

Thus higher education finance, I would argue, is as poorly understood today by most Americans as the health-care finance system was in the late 1980's – and ignorance is not bliss. There are at least four reasons why a muddle-through strategy is not viable.

1) Financial aid has never succeeded in insuring equal access to college. Table 1 reports differences in the proportion of youth receiving post-secondary training in 1992. The first column shows the simple percentage difference in post-secondary training attendance rates by family income, without controlling for other factors that influence the decision. Youth from the top quartile of the income distribution were 28 percentage points more likely to have received some form

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of training and 36 percentage points more likely to have attended a four-year college than those from the bottom income quartile. (The proportion of the lowest quartile receiving any post-secondary training was 63 percent and the proportion of the lowest quartile entering four-year college was 32 percent.)

The second column shows that large differences in attendance rates remained, even after adjusting for objective performance standards – test scores and high-school class ranks. There was an 18-percentage-point difference between the top and bottom income quartiles in both the number of young adults receiving any training and in the proportion entering a four-year college. The third column adjusts for systematic differences in school quality, comparing youth with similar test scores and high school class rank who had also attended the same schools in eighth grade. Youth from the top quarter of the income distribution were 14 percentage points more likely to get any post-secondary training and 12 percentage points more likely to attend a four-year college.

The last column refines the estimate still further, comparing youth with similar parental education, as well as similar test scores and high school class ranks. Note the 10-percentage-point gap in rates of training between the top and bottom quarters of the distribution.

It is not always clear how to interpret these last figures. On one hand, part of the difference in college attendance by family income may reflect differences in parental attitudes toward education, rather than financial barriers. On the other, parental education probably measures more than just parental encouragement for higher education since it is also likely to reflect differences in family wealth, which is a financial barrier and does not show up in family income figures.

As a result, controlling for differences in parental education may overstate the importance of differences in parental tastes for education and understate the differences attributable to parental ability to pay. Nevertheless, the bottom line is clear enough: *Much of the difference in college attendance by parental income remains, even after controlling for nonfinancial explanations for going to work directly out of high school.*

TABLE 2: PERCENTAGE OF STUDENTS FROM FAMILIES IN EACH INCOME QUARTILE WHO ENROLL IN POST-SECONDARY SCHOOLS WITHIN 20 MONTHS OF HIGH SCHOOL GRADUATION

PARENTAL INCOME QUARTILE	NONE	ANY POST-SECONDARY SCHOOLING			
		TOTAL	VOCATIONAL, TECHNICAL	2-YEAR COLLEGE	4-YEAR COLLEGE
HIGH SCHOOL CLASSES OF 1980/82					
Top	20	80	6	19	55
Second	29	71	10	22	39
Third	37	63	11	19	33
Bottom	43	57	12	16	29
HIGH SCHOOL CLASS OF 1992					
Top	10	90	5	19	66
Second	21	79	6	25	48
Third	30	70	7	25	38
Bottom	40	60	10	22	28

What's even worse is that these gaps seem to be widening. Table 2 shows the percentage of youth from each income quartile entering post-secondary schools in the 20 months after graduating from high school in 1980-82 and in 1992. (Students attending more than one type of school are counted in the highest

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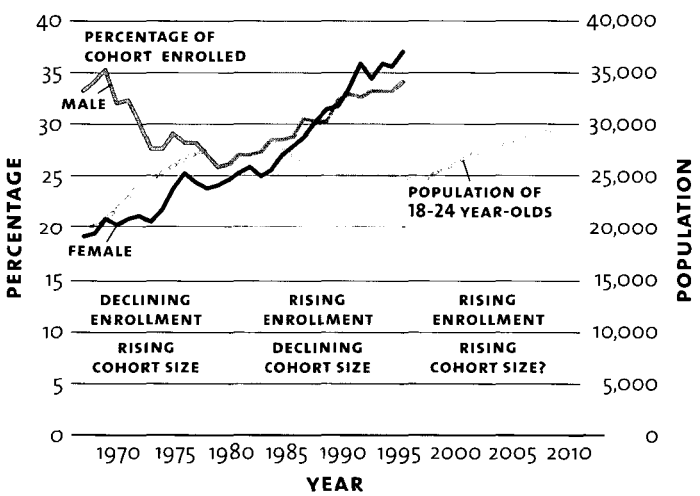
level attended.) The results suggest that while the proportion of high-income youth getting some sort of training rose by 10 percentage points over the decade of the 1980's, the proportion of low-income youth attending college grew by only three percentage points. The comparable gap in four-year college entry grew even more, with the highest income youth raising their entry rates by 11 percentage points while the entry rates of low-income youth barely changed.

FIGURE 1: OFFSETTING TRENDS IN COLLEGE ENROLLMENT RATES AND THE SIZE OF THE COLLEGE AGE COHORT

PERCENTAGE OF 18-24 YEAR OLDS ENROLLED



2) Demographic forces will cause college enrollments to swell over the next 20 years, stretching public subsidies very thin. The first figure shows that changes in enrollment rates since 1970 have been partly offset by changes in the size of the college-age population. During the 1970's, when the big baby boom generation was moving through college, the proportion of men aged 18-24 enrolled in college actually declined from 35 to 26 percent. (Women's enrollment rates did rise slightly – but not as much as male enrollment fell.) Since 1980, this pattern has been turned on its head: Enrollment rates for both men and women have risen by more than one-third, while the number of Americans of college age has been falling.

On balance, these offsetting trends actually saved money for the taxpayers because the number of college-age Americans rose only half as much in percentage terms as enrollment rates (from 7.4 million in 1980 to 8.7 million in 1996). However, taxpayers' luck is about to run out. Between 1995 and 2015, the number of 15- to 24-year-old youth is expected to rise by 22 percent. This change will be even more dramatic in certain high-profile states – notably California – where the college-age "cohort" is expected to rise by more than 50 percent over the next 20 years. *Thus, even if college enrollment rates were to stop rising, policy makers must anticipate that nearly a quarter more students will arrive on campus.* If the states continue to rely on the untargeted, across-the-board subsidies used in the past, they will be hard-pressed to sustain today's low-tuition levels without fierce tax hikes.

3) Although the average payoff to a college degree seems to have increased, the variation in the financial returns to college has widened. Rather than focus only on the difference in the average earnings of those with and without a college degree, children and parents ought to be considering the full

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range of possible outcomes from staying in school or going directly into the labor force.

Table 3 reports the median earnings of men with differing educational attainment as well as earnings in the 90th and 10th percentiles of the wage distribution. While the median earnings of college graduates grew more rapidly than the earnings of high school graduates, the top 10 percent of college graduate wage-earners also grew more rapidly than the wages of college graduates who are least well paid.

These days, it matters a lot whether you end up a lawyer or a social worker. However, it also matters a lot whether you end up as a successful lawyer or an unsuccessful one. The Federal government may have a legitimate role to play in absorbing part of this rising risk to private investments in college. (More on this later.)

4) Because of heightened competition for the most able students, colleges are less able to underwrite need-based financial aid. In 1997, individual institutions disbursed $10.5 billion of their own funds as financial aid, an amount roughly equal to the combined budgets of the Federal- and state-funded "means-tested" grant programs. While it is difficult to pinpoint what proportion of this aid was targeted to low-income students, the evidence suggests that means-tested aid represents a shrinking slice of the pie.

Three trends have limited schools' ability to target aid according to need. Start with declining regional loyalties of applicants, which has led non-needy students to shop around within a wider range of schools. Next, consider the increasing emphasis on student-body selectivity in the published national rankings of colleges, which has increased both the implicit "cost" of admitting a mediocre student with low-income and the value of attracting the superstars. Third, the implicit tax rate on scholarships needed to tailor aid to need has risen.

This last point requires some explanation. Suppose a college wished to provide free tuition to students from families with incomes under $30,000 and to charge full price to families with incomes more than $90,000. In 1980, when the average annual tuition of a private four-year college was $6,800, this could be done by "taxing" family income above $30,000 at an implicit rate of 11 percent – that is, taking away $11 in aid for every extra $100 in family income – in calculating scholarships.

However, educational costs per student have been rising, and so, too has, the tax rate implicit in need-based scholarship formulas. In 1998, average annual tuition at a private four-year college was $14,500. A college that hoped to provide free tuition to the lowest income youth would have to impose an implicit tax rate of 24 percent over the same

TABLE 3: DIFFERENCES IN HOURLY WAGES FOR MALES BY EDUCATIONAL ATTAINMENT (1997 DOLLARS)

	1979	1989	1997
HIGH SCHOOL GRADUATES			
Top tenth of earners	$22.96	$21.30	$20.13
Median	$13.91	$11.92	$10.97
Bottom tenth of earners	$7.20	$6.11	$5.94
Ratio of top tenth to bottom tenth	3.19	3.49	3.39
COLLEGE GRADUATES			
Top tenth of earners	$32.86	$33.18	$34.62
Median	$17.88	$18.28	$17.73
Bottom tenth of earners	$9.49	$8.82	$8.35
Ratio of top tenth to bottom tenth	3.46	3.76	4.15

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$30,000 to $90,000 range. While parents may not be swayed by a tax rate of 11 percent in choosing a school, they are likely to shop harder for an education bargain when the implicit levy doubles.

SOME POSSIBLE REFORMS

Many of the existing subsidies to higher education amount to windfalls, simply subsidizing students to do what they would have done otherwise. Yet, a dollar spent with no effect on behavior still leaves the nation with a dollar less to respond to the needs of low-income youth wishing to go to college. My proposals, described in some detail below, are aimed at increasing the bang from a government buck, retargeting existing subsidies to encourage students to experiment with college and to pool the risk in choosing to enter college.

Proposal 1: "Frontload" the Pell Grant Program for Needy Students. Even after accounting for recent increases, the inflation-adjusted value of the Federal Pell Grant offered to students from the poorest families has fallen by 20 percent since 1980. It may not be realistic to expect Congress to fork over more cash for the grant program. By limiting eligibility to Pell grants to the first two years of college, however, the same amount of money now spent could be focused on encouraging low-income youth to try higher education.

Concentrating grants in the first two years would have a larger effect on youth who need a larger incentive to take the college plunge. But, of course, in easing the pain of entering college, one would also raise the financial hurdle for those passing from their second year to third year.

I think the trade-off is worth it. For a substantial fraction of youth, college amounts to an experiment. Front-loading the Pell grants would allow more youth to try college – to discover whether they are college material. For those who find they want to finish college, there are substantial loan programs to cover the costs.

While it is quite plausible that a dollar in grant aid to low-income youth is more effective in promoting access than an additional dollar in loans, a dollar in grants costs six times as much in the long run.

Proposal 2: Convert the Hope Scholarship Tax Credit and Lifelong Learning Credit into an "Income Contingent" Loan-Forgiveness Tax Credit. The Taxpayer Relief Act of 1997 included a number of new "tax expenditures" for higher education that are projected to cost about $8 billion per year over the first five years. Those tax breaks have been widely criticized by economists for being poorly targeted, for inviting fraud and for being cumbersome to administer.

Such lemons, however, might be converted to lemonade if the money were re-deployed

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Higher Education Finance: Who's Minding the Store?

Most of the money to cover college costs comes from five sources.

State and local governments kick in about $47 billion in operating subsidies annually to public institutions to keep tuition low. This figure is seven times larger than the sums spent on the largest Federal grant program for low-income students and almost twice as large as total borrowing under the Federal loan programs. But because these subsidies are largely invisible, they obscure the true cost of a college education and relieve administrators of the need to justify costs to parents. Students need not apply for their share, and the subsidy is not means-tested.

Means-tested government grant and loan programs represent the second major source of financing. Since need assessments are based on parent's income and assets (as opposed to student's future earnings), the ability to pay is assessed on a backward-looking basis. Although all states have means-tested financial aid programs, the Federal government still provides the lion's share of such aid, primarily through the Pell Grant program, the Federal work-study program and various Federal loan programs. Spending on Federal grant and work-study programs totaled $6.6 billion in 1995-96. Moreover, the Federal government guaranteed $27 billion in new loans for college in that year, including $2 billion in loans to parents of college students. Spending on state financial aid programs totaled only $3 billion.

Third, colleges distribute aid from their own sources. They offer price discounts (a.k.a. scholarships) based upon academic and athletic talent, and financial need. These discounts amounted to $10 billion in the 1995-96. Nearly half of all full-time students at private four-year colleges receive some institutional grant aid. But only 11 percent of full-time students at public colleges received grants from institutional funds in 1992-93.

Colleges enjoy some discretion in distributing Federal grant, work-study and specially subsidized loans. In 1995, they handed out $2.1 billion through such campus-based programs – notably, Supplemental Educational Opportunity Grants, Perkins Loans and Federal Work-Study programs.

Fourth, universities draw on endowment income, but the sums are generally small. In 1993-94, endowment income accounted for just 5 percent of current-fund revenues at private colleges and less than 1 percent at public institutions. Relatively few colleges earned an amount worth considering. The top 10 controlled more than a quarter of total endowment wealth in higher education in 1995.

Fifth, the Tax Relief Act of 1997 created a number of new Federal tax expenditures for higher education. The package of tax credits and tax deductions is expected to cost $41 billion over the first five years, making it roughly the same size as the Pell grant program for low-income youth.

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We would be implicitly taxing a much longer stream of income – the borrower's lifetime income – in deciding who receives the subsidy.

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to programs for sharing risk in the repayment of student loans. The idea is simple: Taxpayers reporting student loan payments exceeding a modest fraction of their adjusted gross income would be forgiven a portion of their tax liability. Borrowers with low earnings would have the choice of taking the refund directly, or having the checks sent to their creditors.

In practice, this would take little new paperwork: Eligible taxpayers would have been identified when they first borrowed the money. By contrast, the Hope Scholarship and Lifelong Learning tax credits are bureaucratic messes. They require participating colleges to confirm that a student is either in his or her first or second year of college, to confirm half-time enrollment status in a degree-granting program and to collect parents' social security numbers to help the Internal Revenue Service determine eligibility. The National Association of College and University Business Officers estimate that all this will cost colleges and universities $137 million in 1999.

A tax credit approach to risk sharing could make use of existing administrative records maintained by the Department of Education and private lenders. As important, since the credit would not affect the loan-collection costs of private lenders, the student-loan industry would not have incentives to oppose the new approach. Indeed, private banks might become strong supporters if taxpayers were given the option to channel their tax credits directly to student-loan creditors.

Such "forward-looking" means testing would have a number of advantages over expanding the "backward-looking" means testing implicit in current student aid programs. First, it would reduce the need to use the currently very high implicit tax rates in scholarship formulas based on parents' incomes for the few years their children are in college. Instead, we would be implicitly taxing a much longer stream of income – the borrower's lifetime income – in deciding who receives the subsidy.

Second, student borrowers – and, indirectly, their parents – would be cushioned against the risk that their careers did not take off. Note, by the way, that it would give parents more justification in asking their children to bear a portion of the cost of college because it would reduce the loan burden on kids who

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later chose poorly paying jobs or were simply unlucky.

Last but not least, states could piggyback on the Federal system, forgiving some of the taxes owed by former students who were poor earners. By the same token, it would serve as an incentive for graduates to stay in the states that educated them.

Proposal 3: Find out which forms of aid really work. While policy options abound, there is currently little empirical basis for choosing among methods for closing the gap in college attendance. For instance, liberals have long focussed on efforts to raise the maximum size of Pell Grants. However, while it is quite plausible that a dollar in grant aid to low-income youth is more effective in promoting college attendance than an additional dollar in loans, a dollar in grants costs six times as much in the long run. Without hard evidence about how grants and loans change behavior, there is little solid reason for preferring one to the other.

Given the amount of tax money at stake, it is time to collect the information that would allow such comparisons. An experiment comparing, say, the impact of better counseling and larger maximum grants or the incentives in different loan packages, could go a long way toward adding some substance to an emotional debate.

There are plenty of precedents. Over the past two decades, both the government and private foundations have sponsored numerous experimental evaluations of the employment and training programs for welfare recipients. More recently, the Department of Labor sponsored an experimental evaluation of the Job Training Partnership Act (J.T.P.A.) program.

However, the dollars at stake in these areas are small compared with the public subsidies for higher education. Federal spending on employment and training programs for welfare recipients totaled $1 billion per year following the Family Support Act of 1988; appropriations under the J.T.P.A. were under $2 billion in the early 1990's at the time of the J.T.P.A. evaluation. By contrast, the Pell Grants alone cost $7 billion per year. States spend another $45 billion in direct subsidies to public institutions, and more than $25 billion of Federally guaranteed education loans are originated each year. Given the magnitude of the public investment at stake, an evaluation is plainly overdue.

CONCLUSION

As the financial rewards for educational attainment have grown, it is no coincidence that calls to reform the education system have become ever louder. In response, reformers have offered a laundry list of suggestions for improving the quality of elementary and secondary education for the disadvantaged – ideas ranging from school choice to national standards to greater accountability at the school level.

Many of these proposals, particularly ones that improve accountability and allow more decision-making at the school level, may well have merit. However, ever since the publication of the Coleman Report in 1966 researchers and policy makers have argued over whether marginal increases in school spending have yielded improvements in student performance. It is now apparent that many have not.

My goal here is to urge that we explore the opportunities for helping youth by extending their training after high school rather than focusing solely on the quality of elementary and secondary school. These proposals need not add to the public budgets for higher education. Their goal is to get our money's worth from what is already spent.

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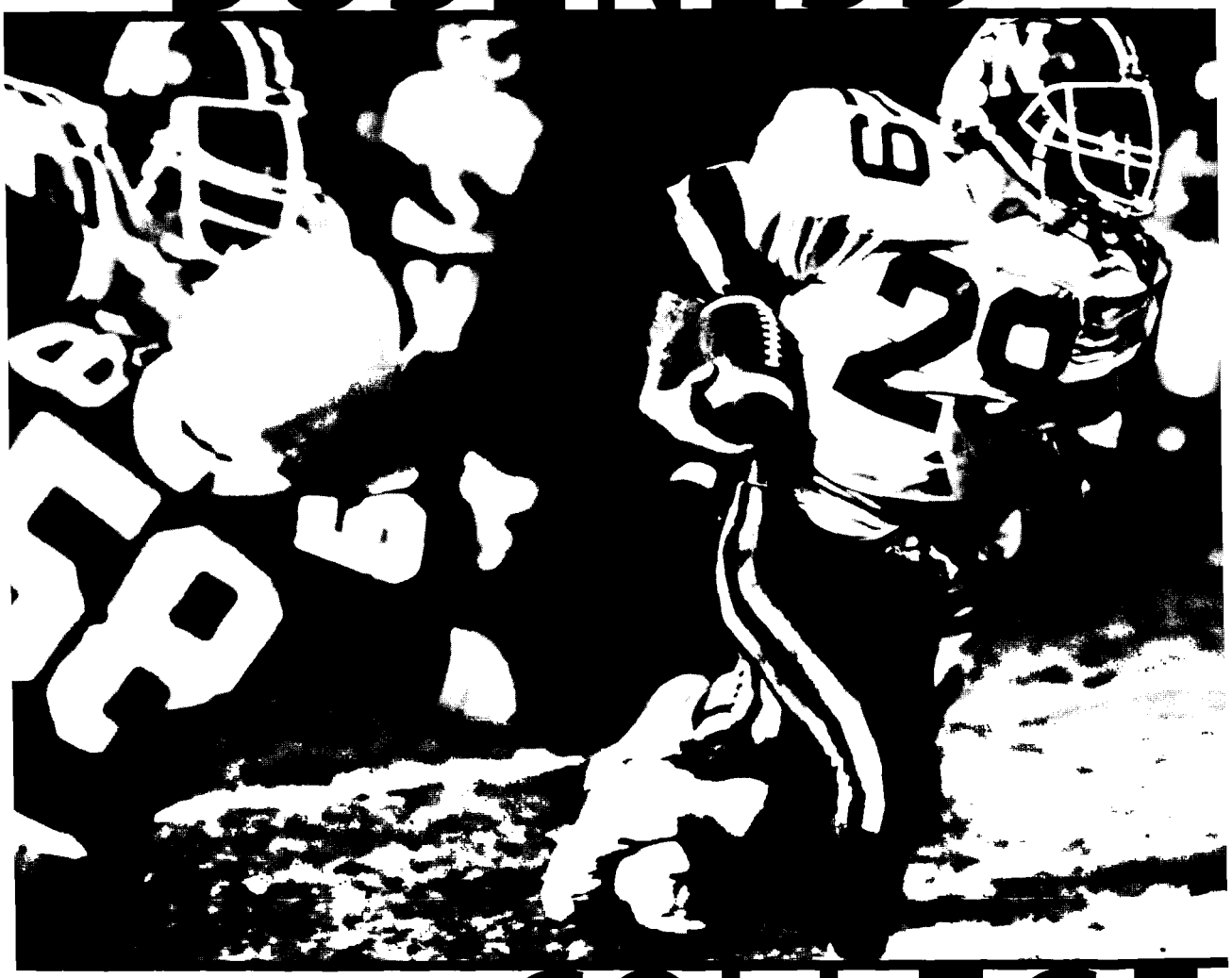
THE BUSINESS OF COLLEGE AND THE HIGH



Why is the NCAA in charge? And why should you care?

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SPORTS
COST OF WINNING

By Roger G. Noll

Intercollegiate athletics is a strange business – one whose profits end up in the most unlikely pockets. But I'm getting ahead of the story.

For some 50 colleges and universities, football and men's basketball are modest enterprises that generate enough revenues to cover full scholarships for about 100 athletes – and, in a good year, to yield a profit of a few million dollars. At a few universities, women's basketball is also profitable, and baseball is more or less a break-even operation. For all other sports, and for major sports outside the top group of colleges, intercollegiate athletics is a financial drain. Yet almost all American colleges and universities field an impressive array of men's and women's teams across a variety of sports that have few players and virtually no spectators.

What's more, intercollegiate sports chronically generate serious controversy that leave college administrators cringing behind their desks. The media regularly report scandals about drug use, criminal activity, excessive financial aid and poor academic performance punctuated by low graduation rates. No less important, big-time sports cause friction among faculty and university administrators. Some see sports as diverting resources and attention to an unimportant – even frivolous – non-academic activity. Explicit favoritism to athletics also is controversial. If coaches are paid more than Nobel Prize winners, if athletes have larger scholarships and better dorms than academic superstars, are colleges transmitting the wrong lessons to students and society at large? And if college sports cast so dark a shadow, why do they endure?

WHY AMERICAN UNIVERSITIES SUPPORT SPORTS

To the rest of the world, American intercollegiate athletes seem like pagan rituals. Universities rarely sponsor athletics teams – let alone encourage them to play before thousands or to appear on television.

The popularity of intercollegiate sports in the United States is not driven by Americans' greater interest in sports. Professional soccer in most high-income nations is more popular – and even more successful financially – than any American sport. In Europe, average revenues per soccer team are in the range of $40-to-60 million per year, placing the teams below American football, roughly equal to baseball and above American basketball. Several English soccer teams are publicly traded companies with market caps between $500 million and $1 billion, putting their market value in the range of N.F.L. teams and above teams in other American sports.

Nor are intercollegiate sports

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popular because more Americans follow sports that first interested them as students. Intercollegiate athletics in the United States has been a popular entertainment since the beginning of the century, when the fraction of Americans who had gone to college was far lower than the proportion of college-educated Europeans and Japanese today.

Finally, the special prominence of American intercollegiate athletics is not explained by television exposure. College sports were popular before radio and long before television. Moreover, since Europe has liberalized broadcasting by allowing cable television, sports on cable has proliferated – but not intercollegiate sports.

So why do American colleges devote so much effort to sports? Primarily, because their students demand it as athletes, not as spectators. Public enthusiasm focuses on the so-called revenue sports – basketball and football. But the vast majority of college athletes play other, minor sports, for which no significant demand exists other than from the athletes themselves. The inescapable conclusion: Universities have comprehensive varsity athletics programs largely because students want to be athletes. And they compete to enable students to follow their interests, whether in physics or field hockey, linguistics or lacrosse.

THE FINANCIAL STAKE IN SPORTS

Colleges and universities follow diverse policies regarding intercollegiate athletics. The vast majority sponsor teams with no expectation of generating revenues. Indeed, the typical intercollegiate sports program is based on the traditional amateur model.

But focusing on the typical ignores the big-time sports schools with multimillion-dollar profit centers in basketball and football, and the many other schools that dabble in the so-called revenue sports. The N.C.A.A. divides colleges and universities into three divisions according to the depth of their financial commitment. The top group, Division I, is further subdivided into I-A and I-AA for football. And even this categorization understates the extent of diversity.

In Divisions II and III, sports are relatively low-cost activities. Most schools use part-time coaches, play only nearby competitors and give few athletic scholarships. These schools can field most teams for $50,000 per year; football, the most expensive, can be had for $200,000. Thus, a college can run a comprehensive intercollegiate program for $1 million a year, not counting capital investments in facilities. This sum is not large compared to a university budget. But a small liberal arts college with 1,000 students may end up spending 5 to 10 percent of tuition on a comprehensive sports program.

At the top of the heap are about three dozen Division I-A schools that compete for national championships in several sports including football and both men's and women's basketball. Just below are another dozen mostly small, Catholic colleges that have the same ambitions in all but football. At these schools, game attendance for the trophy sports approaches the numbers for professional sports. They expect to be in the N.C.A.A. championship basketball tournament and, if they play Division I football, in a post-season bowl.

PUNTING ON FOOTBALL

The financial returns from football can be

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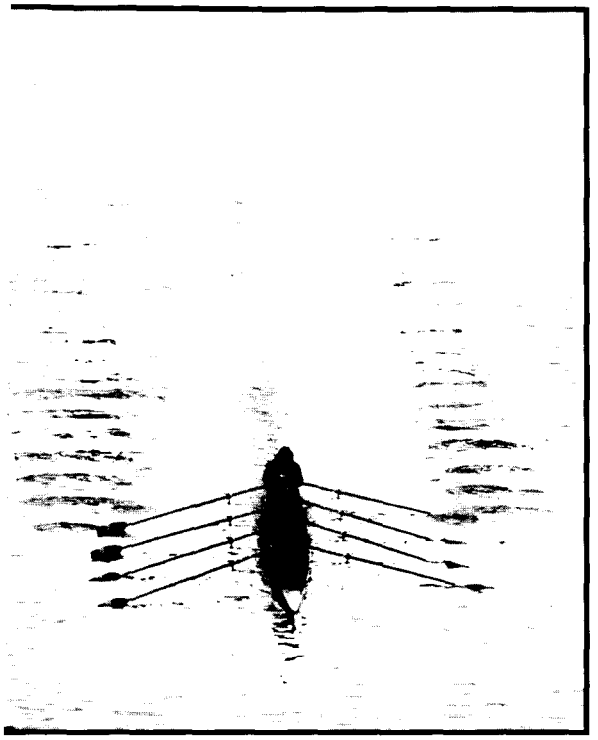

DOUG PLUMMER/PHOTONICA

Why do American colleges devote so much effort to sports? Because the students demand it as athletes, not as spectators.

very large for top teams. Typically, they play six or seven games at home, bribing weaker schools to be cannon fodder against far superior opponents in front of large crowds. For the best of the best, season stadium revenues of $15 million are feasible.

The top teams also expect to appear on television almost every week, with two or three games per season broadcast nationwide. Television generates $2-to-3 million for these teams and sometimes much more, although in most conferences the money must be shared with other conference members. Notre Dame does even better since it sells national television rights to all its home games and does not belong to a conference.

In addition, bowl games guarantee a payoff of about $1 million per team. For teams picked for a top bowl game (one of the so-called "alliance" bowl games), the payoff is several million dollars – although, for most schools, bowl income, too, must be shared with conference members. The dozen schools with the best football teams in the Midwest and South bring in $30 million or more, while other successful schools take in $20 million.

For the rest of the Division I-A football teams and all of the ones in Division I-AA, television exposure is unusual and total ticket receipts rarely top $2 million. Thus, these teams must get by on revenues about one-tenth that of their superpower brethren – a reality that explains why most jump at the chance to earn a few hundred thousand dollars to be drubbed by Penn State or Michigan.

Football team operating costs are driven by the school's business strategy. Does it try to field a ranked team that will go to a major bowl? If so, the team must play interregional foes, running up travel costs of hundreds of thousands per trip. And it must hire a top coach at salaries ranging from $400,000 to $1 million for a head coach.

Management costs typically are attributed to something other than salary – endorsements, in-kind payments (e.g., a mansion, a Cadillac) – in order to keep compensation in line with that of top faculty. But this practice is mainly a public-relations device: Competition for top coaches insures that, one way or another, they are paid according to their ability to generate revenue. By contrast, a team that does not aspire to national ranking can minimize travel costs and rely on mediocre veterans for coaching.

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COLLEGE SPORTS

Stadium operation costs are roughly proportional to attendance, and range from $100,000 annually at the bottom of the heap to $2 million at the top. Thus, all told, a typical Division I-A school might scrape along on a budget of $1 million for outlays other than scholarships, while a big-time Division I-A school can burn $10 million per year.

The major source of differences among teams' financial aid budgets is tuition. Tuition depends on the quality, reputation and scope of activities of the school as well as whether it is public or private. All athletic scholarships include about $12,000 for room and board so that 85 scholarships (the Division I-A ceiling for football) cost about $1 million plus tuition. At leading private universities, tuition runs $20,000 or more, so 85 football scholarships cost about $1.7 million.

Scholarship costs explain why two-thirds of Division I basketball schools do not play in Division I-A football. Athletics departments at private schools need to dish out two or three times more in aid to play Division I-A football as do most public schools. Thus for nearly all private schools in Division I, football revenues can't come close to covering the costs of scholarships, coaches, travel, equipment and stadium operations. So very few opt in.

Tuition does not necessarily reflect actual costs to the university. A key consideration is whether the school is at its enrollment ceiling. At highly rated academic schools – California, Duke, Michigan, Northwestern, Stanford, U.C.L.A., Wisconsin – many applicants are rejected who would be willing to pay all of the university's charges. So the decision to subsidize another athlete is a decision not to admit someone who might pay full tuition.

But where an extra athlete does not displace a tuition-payer, the cost of admitting 85

football players is very small compared to the average cost of providing the education. Thus, if an under-enrolled private school can generate enough revenue from football to pay the tuition of its players, the tuition payments are gravy for the university.

Capital facilities are a very important cost of football. In theory, a university could go into debt to build a stadium, and then cover the debt from its operating budget. But, in practice, capital investments are covered by special fundraising drives or, for public universities, by separate appropriations. The reason is simple: No university generates a large enough surplus to justify the capital expenditures necessary to field a football team.

Profits (neglecting capital costs) from football can exceed $10 million for Division I-A teams that play in an "alliance" bowl game. But returns this large are only possible if football generates substantial donations for both scholarships and facilities. In the bottom two-thirds of Division I, losses typically run $1 million to $2 million per year

MARCH MADNESS

Basketball operates on a smaller gross, but with disproportionately lower costs. Like football, the best basketball schools play more home games than the worst, with cash chang-

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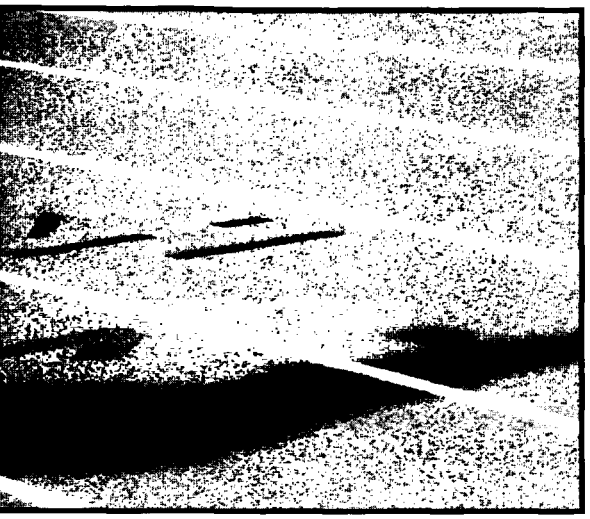

STEVEN EDSON/PHOTONICA

The decision to subsidize another athlete is a decision not to admit someone who might pay full tuition.

ing hands to arrange unbalanced schedules. A dozen Division I men's teams have a home attendance of around 300,000 per season, while some 50 draw more than 100,000.

Colleges ration student attendance to sell more tickets at higher prices. The best men's basketball teams have game revenues of over $5 million per year, plus television revenues of $1-to-2 million more. A few top women's teams take in over $1 million. But most of the 50 or so schools that try to field a ranked team and usually make the N.C.A.A. championship tournament have revenues below this.

The N.C.A.A. has a complex formula, based on past success, for dividing the profits from the N.C.A.A. tournament. Nearly all payments go to conferences that share revenues, so a school's tournament revenue depends more on the success of its conference than its own record.

For conferences that routinely place multiple teams in the men's tournament and typically have two or three teams that go through several rounds of play, the payments amount to several million dollars a year. A men's team from a top conference expects a profit of between $100,000 and $500,000 per year from the N.C.A.A. championship tournament, depending on the league's revenue-sharing rules. Revenues derived from women's teams are lower, but in the top conferences can run to $100,000 or more per team. So, all told, the best men's teams generate $10 million revenue, the top women's teams about $2 million.

Over 300 schools play Division I basketball, compared to over 100 in Division I-A football and about 80 more in Division I-AA. And for the majority, revenues from all sources are usually under $1 million for the men's and women's teams combined.

Basketball is far less expensive than football because teams need pay only 15 scholarships and travel with fewer than 15 players. Coaches are paid about the same as in football, but staffs are smaller. Thus, a modest Division I team can pay as little as $150,000 for coaching, while the big time schools fork out $1 million.

As in football, the cost of a scholarship to the athletics department can run from $12,000 to over $30,000. But even in the latter case, the total team cost is under $500,000. Thus revenue of $1 million is more than sufficient to pay the out-of-pocket costs of a team at a private school, and half that can do the job at an inexpensive public school. The doormats in Division I basketball lose $200,000 at most while the top schools can earn several million dollars from the men and $1 million from the women.

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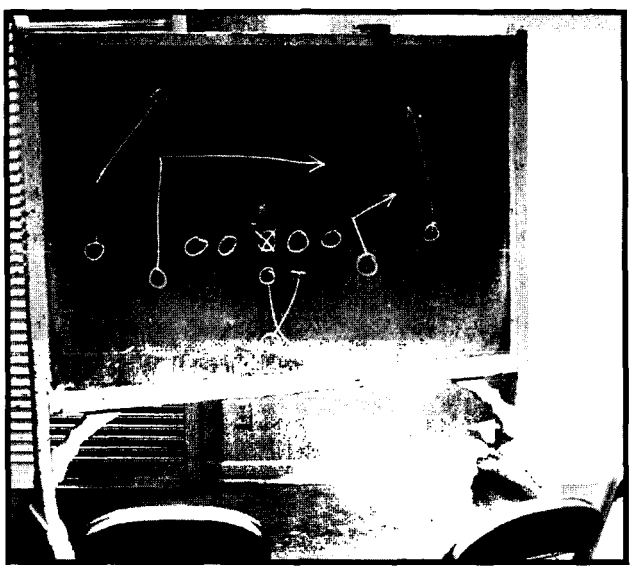
WHAT'S IN IT FOR SPORTS U?

Schools not well known outside their home region can benefit indirectly from a successful Division I team by increasing applications for admission. Whether this actually helps the school, though, depends upon its circumstances. A school at its enrollment ceiling will gain only to the extent that it can be more selective in admissions. But a private school that has trouble filling its dorms can admit more students and collect more tuition. Even an extra 100 students at $20,000 each represents a serious piece of change for the average university.

Some claim that big-time sports can increase donations to academic programs. But several studies have concluded that athletics has essentially no effect on contributions to the school outside the athletics programs. The only plausible source of an indirect financial benefit is through the enrollment effect: If more and better students attend, the university might receive more alumni gifts a few decades later.

The vast majority of departments of athletics do not make a profit, even from the two revenue sports. Indeed, a majority of Division I schools lose substantial amounts on football and, at best, break even on basketball. Thus, for all schools outside (and most in) Division I, intercollegiate athletics is a financial drain – commonly hundreds of dollars annually per student enrolled.

For the top schools that do profit from their revenue sports, the profits are significant. But the money rarely accrues to the academic side of the university. Competition is fierce for high-end coaches – as well as for people who can run big-time athletics departments efficiently. Thus, much of the surplus from revenue sports is spent on salaries.



MARK ADAMS/FPG INTERNATIONAL

Competition is fierce for high-end coaches. Much of the surplus from revenue sports is spent on salaries.

What's more, universities are inclined to spend anything left on unremunerative sports. This phenomenon has been boosted by the requirement for gender equality in varsity athletics. Women have no counterpart to football with its 85 scholarships. So in the wake of legal requirements to balance gender participation in varsity sports, football schools have been forced either to drop some men's sports or to add women's. Schools that make a lot of money on football pursue the second strategy. After all – returning to the

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earlier theme – men and women students alike want more women's sports, not fewer men's sports.

"CHEATING" AND THE ROLE OF THE NCAA

Athletics scandals typically arise from violations of the N.C.A.A.'s rules, and thus are commonly labeled as "cheating" to emphasize the idea that the offending institutions are attempting to gain advantages unfairly. These scandals fall into three categories. The first is excessive financial assistance to student-athletes – under-the-table payments or no-show jobs. The second is toleration of antisocial behavior that does not directly affect athletic performance – drug use, theft, violence or simply low academic performance that would not be tolerated for non-athletes. The third is toleration of performance-enhancing drugs or training regimes that consume most of a student's time. All of these rules violations follow from the financial incentives facing universities and, especially, coaches.

Top coaches' salaries are comparable to top pay in law and medicine. To obtain a job at one of the 30 or so universities that aspire to the first tier in revenue sports, a coach must first win consistently at a lower level. Then, to keep a plum job or move on to the pros, a coach must win consistently against quality opponents. At the very top schools, winning seasons without major bowl victories in football or a shot at the quarterfinals in N.C.A.A. basketball tournament will lead to dismissal.

The basic principle behind the N.C.A.A.'s rules regarding competition for athletes is that it must be limited to two dimensions: the overall college environment and the skills of the coach. Many highly skilled athletes are in college to prepare for professional sports careers. They seek scholarships for one purpose: to obtain experience and training needed to advance to the pros with the least possible disruption to what they do off the playing field. And like other adolescents, some athletes cut class, take drugs, beat up other students and, on occasion, knock off a liquor store if they think they can get away with it.

For a coach, success assures a decades-long career with a salary of hundreds of thousands of dollars. And with few exceptions, coaches have no alternative employment opportunities anywhere near as lucrative. Consequently, a coach facing an athlete who wants extra money (or a free pass on school rules) has compelling reasons to succumb.

Persistent rule breaking by coaches is not likely to go unnoticed by vigilant university administrators. But the incentive to cheat spills over if they regard athletic performance as a way of attracting students or encouraging the generosity of alumni and state legislators. All that is needed to let cheating persist is inattention.

The cheating label is a device for generating adverse publicity that might pressure universities to adhere to the N.C.A.A.'s rules. But looking behind the public relations, much of what the N.C.A.A. and the press call cheating is not ethically questionable.

The N.C.A.A.'s financial rules are incredibly detailed, frequently picayune and vigorously enforced. Isolated minor infractions usually lead to minor penalties: While at Stanford, Tiger Woods regained eligibility when he reimbursed Arnold Palmer for dinner. But repeated minor violations are interpreted as a sign of laxity in a university's enforcement efforts. When U.C.L.A. was placed on probation in basketball, the documented crimes were repeated gifts of T-shirts and Thanksgiving dinners.

THE NCAA CARTEL

Economists who have studied intercollegiate

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sports unanimously agree that the N.C.A.A. is the harshest price-fixing cartel in all athletics, amateur or professional. Recall that an athletic scholarship actually covers only about $10,000 in basic living costs. The rest goes for tuition, books and other fees. For an athlete who has no interest in the educational aspects of being a college athlete, the part of a scholarship that covers academics has no value. If attending college were regarded as more or less a full-time job, the student-athlete could do better working an equivalent number of hours at a fast-food restaurant. The problem from the athlete's perspective is that McDonalds does not field a football team.

Financial cheating arises because an athlete is worth more to a university and its fans than the N.C.A.A. scholarship limit. If five good players can increase the revenue of a men's basketball team from $1 million to $3 million – still a modest amount – these players are worth $400,000 each. Thus if schools were to bid competitively for these athletes, the winning bids would be ten times more than the list price of a year at Stanford.

Where would this money come from? Some, presumably, from subsidies now going to minor sports. Some would come from coaches' salaries, because recruiting superstar athletes would no longer be as profitable. And for a handful of top sports schools, some would come out of profits now used to cover academic expenditures.

The beneficiaries of the N.C.A.A. scholarship rules are thus athletes in other sports, the very best coaches and, in rare cases, academic programs. For the most part, these beneficiaries are either highly paid or from families with above-average incomes. By contrast, N.C.A.A. financial rules harm the star athletes in football, men's basketball and, to a lesser degree, women's basketball – athletes who disproportionately come from lower-income families. Thus, the N.C.A.A. financial rules are primarily a means of redistributing income regressively.

The overall impact of the financial rules varies enormously among schools and students. For a minority of college athletes, including some in minor sports, the main benefit of intercollegiate athletics is preparation for a professional sports career. For those who do become pros, the payoffs are very large and college life is a far more pleasant way to gain experience and acquire training than playing in minor leagues. In this sense, college athletes are not exploited because their alternatives are less attractive.

Nevertheless, the prospects for a pro career are poor in every sport. Each year, about 1,500 men receive Division I basketball scholarships, while 2,000 receive Division I-A football scholarships. Of these, about 150 will ever play an N.B.A. game, and about 250 will ever play in the N.F.L. Moreover, most of the athletes who succeed as pros will come from the elite athletics programs. For players from the bottom half of Division I, the odds against a pro career are about 25:1.

For scholarship athletes who never

Universities are inclined to spend anything left on unremunerative sports. This phenomenon has been boosted by the requirement for gender equality in varsity athletics.

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become pros, intercollegiate sports can provide two other benefits. One benefit – competition itself – is frequently overlooked because of the focus on preparing athletes for pro careers. Nevertheless, this benefit is not trivial.

Then, too, a college degree has a big effect on lifetime income. The return to the investment in college is very high and has increased sharply in the last two decades. Thus for a serious student, a free education at a private university is worth not just the $100,000-plus scholarship, but another $200,000 in the "present value" of the extra income the student will earn over a lifetime.

At the other end of the spectrum, if a school has no academic standards or graduates few athletes, restrictions on scholarships are just an instrument for taking advantage of the N.C.A.A. price-fixing cartel. In the trophy sports, many scholarship athletes do not take academics seriously and very few graduate, so that they do not enjoy the post-graduation benefits of higher education.

For these, the majority of Division I scholarship athletes, college is nothing more than an opportunity to play organized sports for a few more years before facing the reality of adulthood. The nub of the issue about the place of sports on campus is whether these athletes, numbering a few thousand in all sports combined, are better off in college than out. For the most part, they enjoy their college experiences – but not for anything having to do with academics.

R. NAKAGAWA/PHOTONICA

PLAYING BY THE RULES

On paper, the N.C.A.A.'s rules seem to say that college is for athletes ready to benefit from the academic side of school. For the most part, however, the N.C.A.A.'s rules unrelated to money or the games themselves are minimal and rarely enforced. The N.C.A.A. does maintain eligibility rules for both admissions and grades. But these requirements are actually very low – well below the formal admissions requirements for universities and colleges with well-regarded academic programs, including many schools that compete in Division I athletics. Indeed, in the trophy sports only a small fraction of athletes who could play regularly for a top team satisfy the normal admissions requirements of the academically oriented colleges.

To maintain eligibility, the N.C.A.A. insists that athletes be registered as full-time students, remain in good academic standing and make normal progress toward a degree. But since schools are extremely heterogeneous in their academic standards, these requirements boil down to very little. Good standing means whatever the university decides. Normal progress toward a degree means almost nothing, since progress is not judged retrospectively by actual graduation results. Most schools graduate a third or fewer of scholarship athletes in the trophy sports and some graduate none.

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With respect to antisocial behavior, the N.C.A.A.'s basic rule is that athletes should be treated like other students. As a result, if a school does not expel other students for felonies, they need not expel athletes. In most cases, universities' disciplinary actions are taken on a case-by-case basis. And some schools are perfectly happy to field a team of alleged perpetrators who, when they behave the same way in the pros, are suspended.

In theory, the N.C.A.A. also limits the time athletes can spend on sports. But these rules have no bite. If coaches and universities want a longer season, the N.C.A.A. accepts extended time limits. And for some sports, the "season" is the academic year.

The hours-per-week limit is more an accounting formality than a strict constraint. The norm is to practice far more than the limits allow, so that each athlete "voluntarily" decides to commit extra time to training in order to compete effectively against others who devote extra time to training.

By contrast, the prohibition against performance-enhancing drugs is rigidly enforced. Student-athletes sometimes are declared ineligible to compete in N.C.A.A. events after taking prescription drugs for an illness. While athletes often protest the N.C.A.A.'s testing protocols, the strict rules against steroids, painkillers and stimulants definitely serve their long-term interests.

THE TRUE IMPACT OF THE NCAA CARTEL

Step back, and the picture is clear: The N.C.A.A. is mostly a device for "cartelizing" universities while doing little to enforce standards of academic performance and social behavior among student-athletes. With the exception of the prohibition against performance enhancing drugs, the only rules that

are both strict and vigorously enforced pertain to limiting financial aid. Thus, to judge solely by cause and effect, the N.C.A.A. is mostly interested in suppressing payments to athletes in a way that benefits coaches and the athletes who play minor sports.

The N.C.A.A.'s inclinations are also revealed by its other business activities. Until the mid-1980s, the organization required all colleges and universities to give the N.C.A.A. a monopoly in television rights for daytime Saturday football games. The practice ended only after the rule was declared a violation of antitrust law. This court decision led to the proliferation of football telecasts on cable channels, which reduced the total fees collected by colleges, increased the disparity in television revenues among colleges (favoring the strongest football programs) and substantially increased the total number of Saturday games available to viewers.

The N.C.A.A.'s current practice with respect to extra-season games parallels the old practice with telecasts. With minor exceptions, N.C.A.A. teams cannot play more than 11 games. Additional games are only permitted if the game has received advance approval from the N.C.A.A. And the N.C.A.A. controls the number of such games, along with which teams can be invited to play and what finan-

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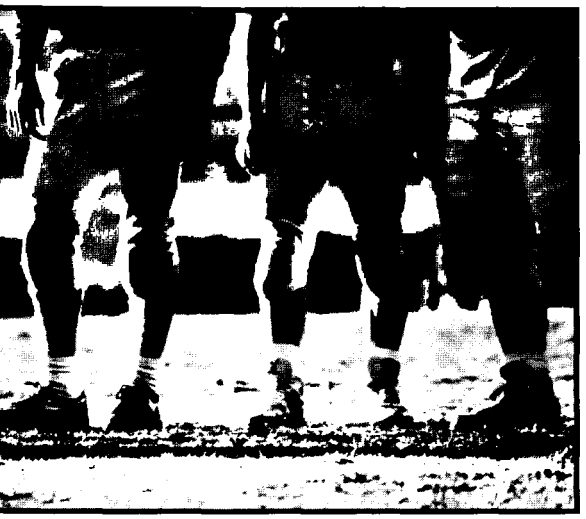

WILHELM SCHOLZ/PHOTONICA

Financial cheating arises because an athlete is worth more to a university and its fans than the NCAA scholarship limit.

cial guarantees must be provided by game sponsors. As with the old TV arrangements and the present scholarship limits, the N.C.A.A. is acting as a classic cartel: restricting output to maximize profits.

The N.C.A.A.'s rules on the number of games go far beyond what is necessary to limit the demands on athletes. That objective could be achieved by a much simpler rule – say, by entitling every college football team to play 11 regular-season games, one preseason special event, one postseason bowl game and one league championship game. But schools and sponsors could determine through the market how many extra-season games would be played, and how much sponsors pay colleges to participate. The main effect, if not purpose, of the differences between the simple rule and existing practice is to increase revenues to colleges.

This cynical conclusion is not intuitively obvious, and to some seems to deny the organization's history. Early in the century, football came very close to being banned because it had become so violent and dangerous. The N.C.A.A. rewrote the rules of play to solve this problem, and hardly anyone would dispute the legitimacy of this role.

A few decades later, as intercollegiate football became more important many schools abandoned the principle of a student-athlete, and became professional operations. The N.C.A.A.'s present limits on the number and value of scholarships and its academic requirements arose to combat this professionalization.

But the N.C.A.A.'s rules do not prevent professionalization among universities that seek to pursue it. Indeed, by making certain that coaches and schools – not athletes – are the main beneficiaries, the N.C.A.A. makes the problem worse by giving them a reason to abandon academic values in pursuit of athletic glory.

ARE INTERCOLLEGIATE SPORTS A DESTRUCTIVE INFLUENCE?

Perhaps 50 colleges and universities participate in trophy sports to generate revenues, with the benefits going in part to coaches and athletic administrators, in part to other sports and, in a few cases, to academic programs. For all other sports, and even for trophy sports at all but the top programs, intercollegiate sports exist not to make money but to please important constituencies – primarily students. If all universities collectively banned intercollegiate sports or athletic scholarships, higher education as a whole probably would be stronger financially than it is.

But this is far from the complete story.

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Most colleges and universities also would be better off financially if they agreed to eliminate comparative literature and advanced mathematics. The difficult question is whether varsity sports bring enough value to universities to offset their costs. And part of the answer revolves around the scandals that surround athletics.

Scandals embarrass universities and undermine their moral authority as transmitters of social values. But scandals are not intrinsic to intercollegiate sports. Intercollegiate athletics create scandals only in schools that are powers in trophy sports – or seek to become powers.

The incentive of coaches to win is a necessary component of the incentive to break the rules. And much of this is created by the cartel aspects of the N.C.A.A's rules, which limit the cost of all programs and substantially increases the profitability of trophy sports at top schools.

If the N.C.A.A. behaved less like a cartel, the financial benefit of on-field success would be smaller. In turn, salaries for top coaches would fall, and schools would have less reason to recruit athletes who seek only a pro career and not an education. Moreover, relaxed rules would lead to fewer violations and fewer scandals. Cutting to the chase, if colleges had to pay something closer to market value for top athletes, they would admit fewer of them and be less interested in athletes who are likely to be behavioral problems.

The economics of intercollegiate athletics is not a story of administrators willfully perverting academic values for the fast buck. Such things do happen, but this is not an accurate characterization of the vast majority of intercollegiate sports programs. The more fundamental force driving college sports is the intense interest that so many students and alums have in sports. And the idea that colleges would abandon something as universally popular as intercollegiate athletics is a fantasy.

But things could be far better. Higher education and society at large would be better served if the N.C.A.A. did not limit scholarships or set the price for postseason events in trophy sports.

OPTIONS

Breaking up the N.C.A.A. cartel is probably as unrealistic a goal as banning intercollegiate athletics. Any effort to eliminate the cartel aspect of the N.C.A.A. would probably lead many Division I schools to set up a rival organization that adopted the practices the N.C.A.A. now follows. If the schools that value athletics most highly all joined the new cartel, reforming the N.C.A.A. would have little effect.

So what, if anything, can be done? Perhaps, not much.

Too many people currently involved in sports, from coaches to athletes in non-trophy sports to the commercial interests that cohabit with best college sports programs, would fight hard to preserve the business as

If attending college is regarded as more or less a full-time job, the student-athlete could do better working an equivalent number of hours at a fast-food restaurant.

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usual. Moreover, as the demand for revenue sports rises along with affluence and leisure time in America, the financial incentives to do well in trophy sports will only grow. The future is likely to be a larger version of the past.

But for optimists in the crowd, there are a couple of plausible routes to reform. The first is to attack the N.C.A.A. through antitrust laws. The N.C.A.A. has already lost its television monopoly this way. And an unrelated antitrust suit forced a consortium of elite universities to abandon collusion on need-based financial aid. But an antitrust suit would be is slow and expensive. And it would probably require the active involvement of the Antitrust Division of the Department of Justice, which is notably uninterested.

DAVID MADISON/TONY STONE

The Justice Department's reluctance is understandable: The Federal Trade Commission was barred from attacking the N.C.A.A. on the ground that it is only allowed to enforce competition in for-profit markets. Moreover, unlike the television case in which some universities had financial incentives to break the N.C.A.A.'s control, private parties are unlikely to pursue the antitrust route on scholarships or postseason play.

Another way to castrate the cartel would be to alter the existing rules in ways that change the universities' incentives. One might base the number of scholarships a school can offer on the academic success of its scholarship athletes. I can imagine a system in which a university is allowed the full limit of scholarships in a sport if its graduation rate over the past few years exceeded, say, 30 percent. For each five-percentage-point shortfall, schools would lose 5 percent of their scholarships in that sport.

A more radical possibility is to convert the current limit on the value of an athletic scholarship to a budget ceiling on all payments to athletes – much like the salary caps in some professional sports. For example, if a school presently awards 15 basketball scholarships worth $20,000 each, the new rule would allow it to spend up to $300,000 in financial aid for basketball on as many students as it sees fit. A school could decide to "hire" Kobe Bryant for $300,000 (to give him an attractive option to playing in the N.B.A. after high school) and use walk-ons for the rest of the roster.

The key to change in all these proposals parallels the general drift of economic policy reform in the past three decades: rely more on incentives and less on rules. The practical way to make the values of intercollegiate sports more closely parallel the academic values of universities is to give universities less incentive to abandon academic values.

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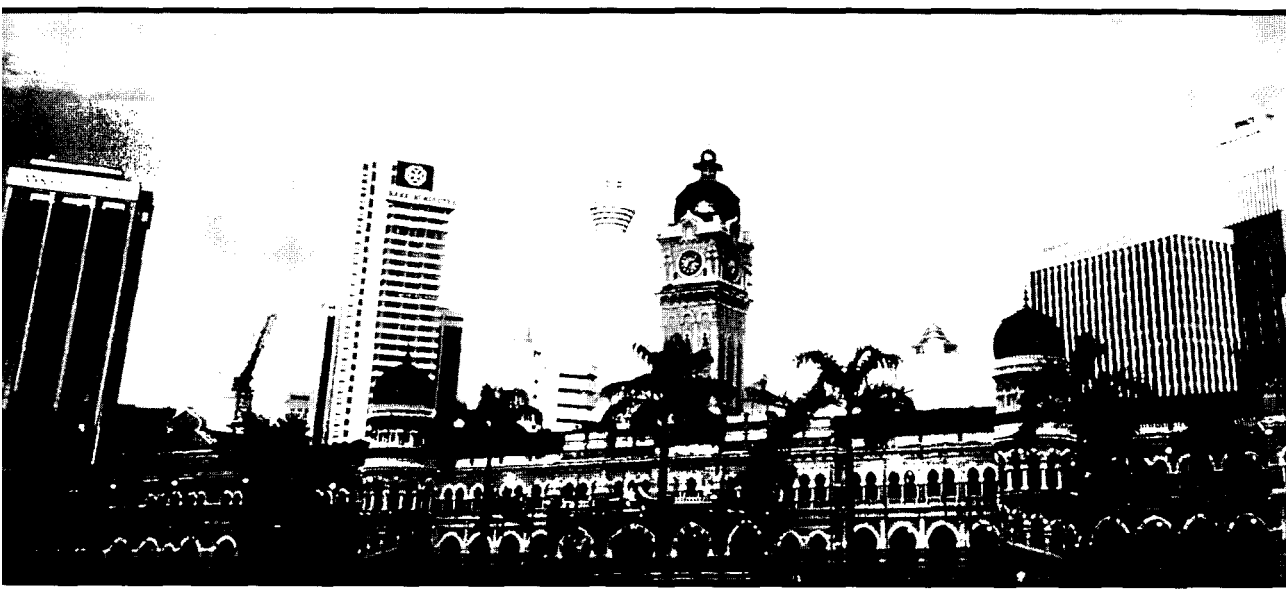
RESTRUCTURING
A Progress



East meets West in Kuala Lumpur.

BANGKOK, THAILAND, MARCH 11, 1999 *An Australian executive working for Deloitte Touche Tohmatsu was shot dead here on Wednesday morning while on his way to a sugar mill which his firm is assisting in financial restructuring, police said. Michael Wansley, 58, was shot eight times by a gunman on a motorcycle and was pronounced dead on arrival at hospital. Wansley was travelling in a van driven by an employee of the sugar mill, an affiliate of Ruampol Industries, along with four Thais – two men and two women. Police said certain groups of people do not want the restructuring to succeed for fear of losing their interests.* —The Nation

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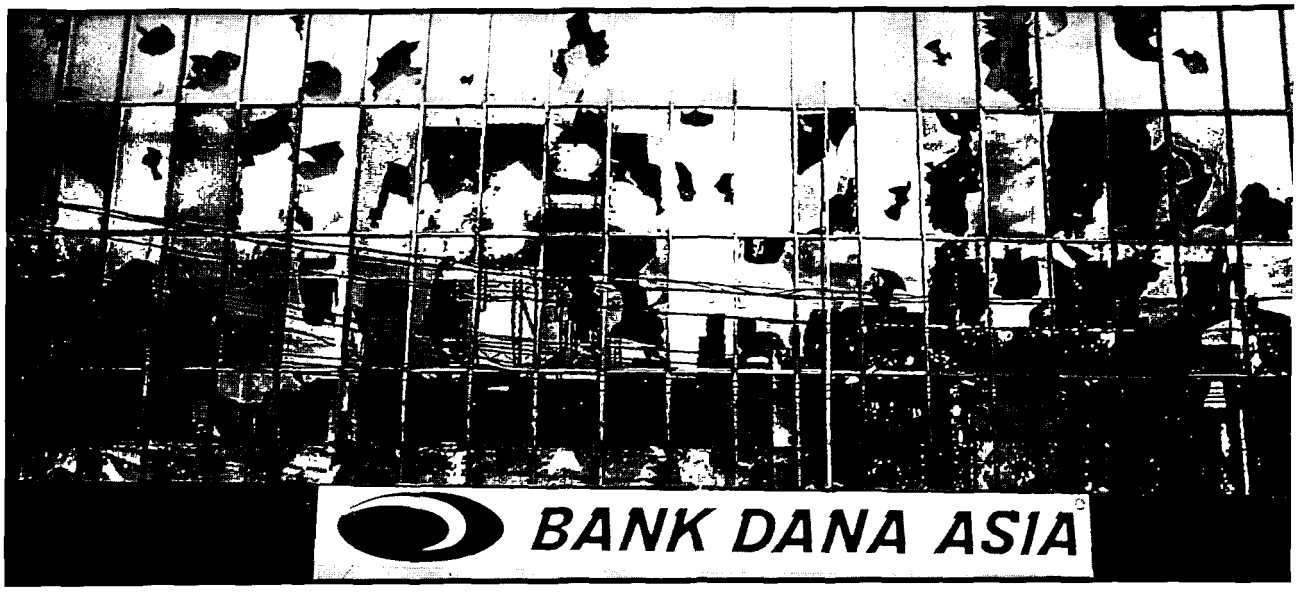
EAST ASIA Report



Somebody down there doesn't like us.

by Uwe Parpart

The murder of Michael Wansley, carried out by professional hit men, made headlines worldwide. And it prompted a Bangkok meeting of the "Big Five" international accounting firms to warn that debt restructuring in Thailand would not proceed if local authorities could not assure the safety of their personnel.

Fair enough, though the Deloitte Touche Tohmatsu country manager and local staff (numbering over 500) should have known that they were sending the locally inexperienced Wansley into a dangerous situation without taking precautions. These days, expertise in risk assessment – on which D.L.T. prides itself – cannot prudently be limited to financial risk.

This time, there really is light at the end of the tunnel.

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RESTRUCTURING EAST ASIA

Even in the boom years of the early 1990's, battles over market share or political rows over wealth distribution in East Asia were never pretty: The going price in Thailand for a drive-by killing was just $1,000. But now that the very existence of businesses is at issue, things have gotten really nasty: The price for assassinations is down 30 percent.

That's the situation on the ground – one playing out somewhat differently in Thailand and Indonesia than in Korea or Malaysia – as losses from some $300 billion in bad loans are being off-loaded in the process politely called "debt restructuring." The $300 billion figure, by the way, does not include losses in China or Japan, or an estimated $1 trillion in lost stock-market capitalization in East Asia.

After an initial spurt of activity that saw enactment of new bankruptcy laws and foreclosure procedures in most of the crisis economies, progress has been slow. And, ironically, recent gains in equity markets and stirrings of industrial recovery are adding to the inertia: Why restructure or sell when return of the good times is just around the corner?

Still, there can be no question that Asia must bite this bullet or be in danger of biting the dust. Should the financial and political systems prove as inept at deciding who will bear the losses as they previously were at passing out loans, recovery will be hard to come by.

On the other hand, it is clear that, once the debt logjam is broken, capital markets will be far friendlier to entrepreneurial initiative than in pre-crisis days. The dozen or so political/business cliques that have ruled the roost for decades in each East Asian country will not be left to beg for handouts. But their share of wealth – and influence – will be greatly reduced.

Meanwhile, each government's need to raise money for deficit spending and rehabilitation of its financial system is for the first time creating lively and liquid markets in debt securities – markets that will challenge the dominance of banks bred to a world of crony capitalism. Indeed, capital is being "democratized" on a scale unthinkable before the Asian crisis. As this drama plays out, capital markets are bound to become more efficient at channeling resources to profit-driven industries.

THE LOSERS – AND THEIR LOSSES

The businesses that Michael Wansley was attempting to restructure before he was shot had racked up some $450 million in debt – a respectable tally for a bunch of sugar mills in the boondocks. And sugar got only a modest piece of the action: The largely unrecoverable loans extended to political and business cronies by the Bangkok Bank of Commerce, Thailand's most notoriously corrupt bank, reached $2 billion before the institution was finally shuttered in November 1998.

But wait, the numbers get a lot bigger. The 56 finance companies closed by the Thai government in 1997 held some 900 billion baht ($25 billion) in assets, which are being auctioned by the country's Financial Restructuring Authority (F.R.A.) for 10 to 30 cents on the dollar. The non-performing loans held by Thailand's banking system are currently estimated at 2.7 trillion baht ($73 billion) and represent nearly 50 percent of all loans outstanding – not to mention 50 percent of Thailand's G.D.P. Some $50 billion in bank debt will likely go down the drain.

Those are scary figures. Some combination of investors and taxpayers, domestic and for-

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eign, will have to take a hit of $70 billion or more from bad loans, not to speak of the additional tens of billions of dollars in equity markets losses and real estate depreciation.

In Korea, Malaysia and Indonesia, credible estimates of net loan losses run around $200 billion. It is worth noting, though, that Korea and Malaysia have made better progress getting non-performing loans off the balance sheets of lenders.

As an aside, it is astonishing that, in the words of the Bank for International Settlements, European bank lending was "well sustained until the very last stage of the crisis." So, don't just blame Asian crony capitalism for the current malaise. Plenty of foreign banks now bewailing the need to take haircuts, lent with reckless abandon.

The dozen or so cliques that have ruled the roost for decades in each East Asian country will not be left to beg for handouts.

As loan losses are recognized on balance sheets, the impact on the wealth of the families that for decades have dominated business in East Asia is dramatic. When a Thai-Chinese media tycoon held a fancy lawn party in November 1994 to inaugurate his swank Bangkok corporate headquarters, superstar Chinese actor John Low and members of the Beijing Opera and Symphony were on hand to mark the occasion, and the beverage of choice was Chateau Margaux. Three years later, when Chatri Sophonpanich, the boss of the Bangkok Bank (Southeast Asia's largest), invited members of Thailand's best-known business families to a year-end party, the proffered drink was Coke. To rub in the point, the bank boss greeted his guests not as his fellow tycoons, but as "the millionaires of yesterday."

Stijn Claessens and Simeon Djankov of the World Bank, along with Larry H.P. Lang of the University of Chicago, have documented the concentration of wealth before the Asian crisis. They found, for example, that the top 15 families controlled well over 50 percent of business in Indonesia, the Philippines and Thailand. In Hong Kong and Korea the comparable figure was 35 percent; in Malaysia and Singapore, about 30 percent.

BEVERLY BROWN/PHOTONICA

This is now rapidly changing as the result of bankruptcies, debt restructuring and bank recapitalization. Top family holdings have been diluted and ownership is becoming far more widely dispersed with foreign ownership, in particular, increasing rapidly.

In Thailand, the total wealth of the richest 20 business families is now no more than 20 percent of what it was in pre-crisis days. Two of the 15 commercial banks are in foreign hands and, by early next year, foreigners will control another four. Numerous surviving finance and securities companies have met the same fate, as have some of the large Thai-controlled manufacturers. In all, only two of Thailand's 20 wealthiest families (the ones operating hotel and telecommunications businesses) have emerged unscathed.

In Indonesia, the shift in wealth will likely

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be even more drastic. The disenfranchisement of the Suharto family, which once controlled over 400 businesses, will make a big difference. And the fact that one of Indonesia's largest and once-proudest private banks, P.T. Bank Bali, is now passing into foreign hands (Standard Chartered) is an indicator of things to come.

In Korea, two of the country's top five banks (Seoul Bank and Korea First Bank) have been nationalized and are in the process of being sold to foreign investors. Even the big five *chaebol* (business conglomerates) are no longer immune to foreign inroads – though President Kim Dae-jung has yet to deliver on his avowed goal of cutting them down to size.

Only in Malaysia, where Prime Minister Mahathir Mohamad and his ruling UMNO. party have successfully resisted pressure to ease foreign access and have chosen bailouts as the preferred mode of dealing with insolvencies, has change in ownership been slow. Danaharta, the country's bank restructuring and asset management agency, has thus far purchased some $7 billion of the estimated $25 billion in non-performing loans at 50 percent or greater discounts. And it is beginning to sell them off – even to foreign investors. But key business groups with close ties to the ruling party remain politically protected and change will be far slower than in Thailand, Indonesia and Korea.

THE POLITICS OF CRISIS

Early this year, half a dozen members of the Thai Senate, an unelected body with substantial oversight powers, traveled to Washington to air their complaints. They had heard that Congress was highly critical of the role of the I.M.F. in Asian crisis management. And they expected a sympathetic hearing.

Their beef: The I.M.F. was imposing unreasonable conditions on both the content and speed of enactment of new bankruptcy legislation. That several of them were large debtors who stood to lose everything once the new rules were on the books went unmentioned. But they had misjudged Congressional sentiment, and returned to Bangkok red-faced and empty-handed. No one, it seems, had told them that United States legislators objected to the use of American taxpayer money to bail out the likes of the honorable Thai Senators.

Still, the fight over the bankruptcy law and proposals to liberalize foreign access to business and the real estate dragged on until April. All told, it took a full year to get the new laws passed. Thailand's first bankruptcy court put out its shingle in June with only 13 judges, though 60 are needed to handle the expected case load.

Meanwhile, rationalization of corporate debt, in the words of Financial Restructuring Authority chief Amaret Sila-on, has been "excruciatingly slow." Of nearly 400 major cases identified last October by the Bank of Thailand's Corporate Debt Restructuring Advisory Committee, less than 10 percent have been resolved.

The reason? Amaret offered the four C's in a speech in Hong Kong in May. Cronyism, collusion, corruption and complacency, he said, are the "four modern horsemen of the apocalypse" for Thailand. "Unless these perverse social aspirations are kept in check, bank restructuring – or any restructuring for that matter – will be ineffective and gains will be short-lived."

There are "strategic debtors" – debtors able but unwilling to pay – aplenty, and they include some of Thailand's largest corporations. But bankers are reluctant to call old business buddies on the carpet, preferring instead to wait things out and find new

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sources of capital even at the expense of diluting their own holdings.

The biggest mistake both he and the Bank of Thailand made, explains Amaret, was to "underestimate the backlash" from vested interests. Indeed, the "nationalist" parliamentary opposition is accusing the reform government of Prime Minister Chuan Leekpai of selling the country to foreigners on the cheap.

In Indonesia, politics has opened since the May 1998 ouster of the repressive and corrupt regime of President Suharto. The parliamentary elections, held in June, have restored a degree of investor confidence in the country.

Cronyism, collusion, corruption and complacency, Amaret said, are the "four modern horsemen of the apocalypse."

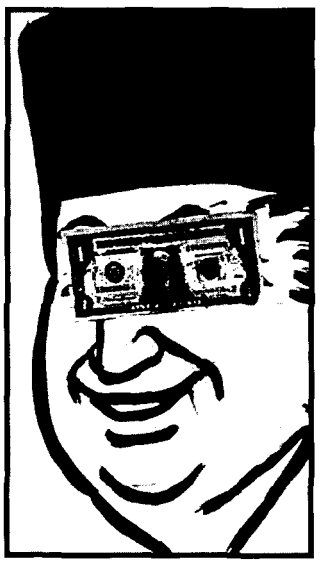
But that doesn't mean an early resolution of the country's banking and corporate debt crisis is in sight.

Efforts to delay reform of the antiquated bankruptcy legislation going back to the Dutch colonial period were unsuccessful. The new law has been in place since September 1998, and a new commercial court was established soon thereafter.

But only 50 or so bankruptcy petitions had been filed as of March, and less than one-third have resulted in bankruptcy judgements. The rest were rejected on spurious grounds or are still pending. Indeed, not a single major debt-laden conglomerate has even faced bankruptcy petitions from its lenders. Two high-profile cases brought by foreigners against smaller companies were either thrown out by the Jakarta Commercial Court or later overturned by the country's Supreme Court.

As in Thailand, political collusion has prevented some cases from getting to court. In others, just plain inexperience with the new legal procedures has prevented satisfactory settlements. Business cultures don't change overnight.

Korea has had adequate bankruptcy laws for years. And enforcement, once a case is brought, is not a major problem. But as noted before, debt restructuring is a thorny political issue in Korea. A popular reform president is struggling to disentangle cross-shareholding among the *chaebol*, with financial institutions and bureaucrats colluding to keep it tangled. A year ago, Kim extracted a commitment from the five largest *chaebol* to bring their debt/equity ratios down to the 2:1 range. And guess what: They did.



Or at least they claimed they did. On closer inspection, it turned out that their actual debt had not been reduced by a penny, but that creative accounting endorsed by the government bureaucracy had done the trick.

Foreign executives based in Korea have time and again warned that failure to reduce the debt load of the *chaebol* will make the current business recovery unsustainable. President Kim sees it the same way, and has both the popular backing and political will to see

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the fight through. But it would be a huge mistake to assume that the family oligarchs controlling the *chaebol* will roll over any time soon.

On a recent assignment to Seoul, I had the opportunity for an off-the-record chat with a feisty *chaebol* chairman. "Debt is a political power issue," the man said. "Debt is leverage. We are too big to go under; Chrysler was too big to go under. Why should we convert debt to equity and dilute our holdings?" Doesn't that say it all?

There is an important point to add in Malaysia – not an excuse, but perhaps an insight into Malaysian leaders' reluctance to take on the corporate sinners.

In 1969, the new Malaysian state was nearly destroyed by ethnic riots. It was a formative experience for Malaysia's current leaders – notably Prime Minister Mahathir Mohamad and his economic czar Daim Zainuddin. And, no doubt, memories were stirred in May 1998 when Indonesians rioted, Jakarta's Chinatown was ransacked and ethnic Indonesian Chinese refugees fled to Malaysia by the tens of thousands.

This is not the sort of stuff that I.M.F. officials or American institutional investors normally give much weight to. But it is the business of political leaders entrusted with the responsibility for keeping a volatile multiethnic society on an even keel.

Mahathir's claims that foreign hedge-fund operators caused the Asian crisis are patently silly. The harsh judicial treatment meted out to his former deputy Anwar Ibrahim was a travesty of justice. And capital controls did little or nothing to restore Malaysia to economic health.

But the country did stay in one piece and experienced little of the social disruption or hardship that hit Indonesia, Korea and Thailand last year. Capital controls allowed an easing of credit in Malaysia well in advance of the rest of East Asia. The controls also cushioned the fall of the Malaysian economy and prevented a bad economic situation from being transformed into an untenable social and political one.

Investors are well advised to take such political factors into account. One day soon, I predict, Mahathir will abandon capital controls with a flourish.

"We are too big to go under," explained the feisty chaebol chairman. "Why should we convert debt to equity and dilute our holdings?"

DEMOCRATIZATION OF ASIAN CAPITAL?

Reeling under the impact of currency devaluation, evaporating stock values, insolvent banks, collapsing corporations and skyrocketing unemployment, East Asian governments responded with alacrity in their first crisis year. Most liberalized markets and removed restrictions on foreign ownership. Indeed, a decade of "normal" development would not have brought the changes that one crisis year prompted with little opposition.

Meanwhile, substantial changes in wealth distribution and corporate control are breaking the stranglehold of a few oligarchical families. To date, foreigners are the main beneficiaries. At the onset of the crisis, there

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were no foreign-owned financial institutions or securities firms operating in the crisis countries; next year, there will be dozens. By the same token, foreign holdings in East Asian industrial corporations will have increased nearly tenfold by the end of 2000.

Few analysts doubt that a recovery is under way – a conviction that is mirrored in both stock-market indices and GDP growth figures for the first half of 1999. Unfortunately, though, this has encouraged large numbers of local firms and politicians to believe that debt restructuring can be postponed indefinitely. And that is the current Achilles heel of the recovery process. Should complacency prevail, the good news will be buried in another decline.

In the end, the political will and savvy of the region's new reform-minded middle class will determine the outcome. And happily, betting on East Asia's middle class is looking like a good wager.

In Thailand, the government of Democrat Party Prime Minister Chuan Leekpai has weathered several storms. Next year's elections under the new, more liberal constitution enacted in early 1998 will either bring him back or see him replaced by the equally reform-oriented telecommunications tycoon, Thaksin Shinawatra.

In Indonesia, the leading candidate for president, Megawati Sukarnoputri, the daughter of first post-independence president, rode to parliamentary victory on the shoulders of the urban middle class. Whatever her political and economic policy shortcomings, she will not betray her reform mandate. Neither, I would argue, would any compromise candidate who gained the top office in Indonesia.

In Korea, President Kim is so firmly in the saddle that even his supporters worry about excessive presidential power. But he did not endure prison and years in exile just to turn around and ditch his reform agenda.

Malaysia's Mahathir, I predict, will prove that he can win one more election and then call it quits. His successor, no doubt from Mahathir's UMNO party, will cautiously embark on a reform course already mapped out by current economic advisers. Thus, while the guardians of the past may delay political and financial reform, that is all they will be able to do.

East Asia's new leaders will be greatly strengthened in their quest by two seemingly incidental developments in the region's finances. Governments, whether in Thailand or Korea, Indonesia or Malaysia, have been forced to issue bonds in unprecedented amounts in order to write down bank liabilities and to cover deficit spending. At the same time, corporations have discovered the advantages of bonds over bank loans at a time of contracting bank lending. Meanwhile, newly established (in Thailand) or existing secondary equity markets (in Korea and Malaysia) are making it easier for medium-size industries to raise capital.

Liquid markets in debt and equity will no doubt eclipse banks as financial intermediaries in Asia – just as they did in the United States. And that will lead to greater financial transparency, more reliable market valuation of corporate assets, and, ultimately, to capital access for deserving new ventures. Another serendipitous result: wider participation of households in capital ownership, along with mobilization of middle-class savings for sustained economic growth.

But perhaps the most important benefit of more efficient markets will be political. As the democratization of capital is increasingly perceived as a liberating force, the comeback paths for the oligarchs will be cut off and political democracy will take root. M

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the SAVINGS CRISIS

in the Eye of the Beholder?

By William G. Gale and John Sabelhaus

In the fall of 1998, personal saving, as measured in the United States Government's official National Income and Product Accounts (N.I.P.A.), dipped below zero for the first time since the Great Depression. For the entire year, personal saving totaled just one-half of 1 percent of after-tax income – the lowest since 1933.

Are you worried? Join the crowd. But all is not lost – indeed, all may be fine and dandy. For the closer one looks at the saving "crisis," the harder it is to draw firm conclusions. And while we would by no means dismiss the issue as a misunderstanding, it is apparent that the official saving statistics mean little in the abstract. From one perfectly reasonable perspective, saving rates are higher today than they have been since the 1950's.

For most purposes, the savings rate is just fine, thank you.

Confused? Settle back for some serious bean counting. The issues are complex, but understanding them is worth the effort.

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THE CURRENT STATE OF PLAY

Those who have been following the saving statistics for some time have had little reason to be surprised by the dip to zero and below. After all, N.I.P.A.'s personal saving rate has been on a downward spiral for some time, averaging 8.2 percent of GDP in the 1970's, 6.7 percent in the 1980's and 4.8 percent in 1990-94, before dropping to 3.0 percent in 1996 and 2.2 percent in 1997.

But it seems a lot of other people were taken aback. For saving disappeared entirely just as pundits had succeeded in focusing attention on the question of who would pay for the retirement of the baby boomers.

Actually, at least two views of the decline have been clawing their way into the collective consciousness. Those primarily concerned with the growth of the economy view low saving as unadulterated bad news, arguing that it is bound to lead to inadequate accumulation of capital. At a macroeconomic level, low saving makes America ever more dependent on fickle flows of foreign capital; at a micro level, it raises fears that aging wage-earners are burning the candle at both ends.

By contrast, those concerned with sustaining aggregate demand in the near term interpret the low saving rate as good news. Echoing an earlier generation of Keynesians scarred by the Great Depression, they argue that the decline in saving – or rather its flip side, the accompanying rise in consumption – has fueled the long boom in America and is propping up a global economy weakened by the currency collapse in East Asia. They worry that households will soon retrench, driving the global economy into recession.

Personally, we find more validity in a third, more technocratic view, best summarized by William Nordhaus of Yale, who noted a few years ago that the "tools for measuring saving and investment are stone-age definitions in the information age." Standard saving measures correspond only weakly to the concepts of saving used in economics.

That does not rule out the hypothesis that saving is too low or, for that matter, that a consumption binge is needed. But holders of this view would not draw these (or any other) conclusions from the official saving numbers. Our goal here is to show how measures closer to what economists have in mind affect recent trends. We do not attempt to determine the causes or consequences of the saving decline. Indeed, some of our measures suggest that the saving rate is rising, not falling.

SO, WHAT IS SAVING ANYWAY?

According to Econ 101, saving is what's left-over from today's consumption that could be consumed tomorrow. With this idea in mind, saving is alternately defined as "income" minus "consumption," or the change in "wealth," or the change in the supply of "capital." If each of the terms in quotation marks could be pinned down and measured consistently, all three definitions would amount to the same thing. In practice, though, there's

CORBIS (2)

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many a slip twixt cup and lip.

Start with the fact that the simplest definition, income less consumption, flounders on the question of defining income. Add the fact that saving measures differ in their breadth. A narrow measure, often used in studies of households, focuses on changes in financial assets and liabilities. A very broad measure – the stuff of macroeconomics – would include changes in the value of financial, physical, intangible, human, public, natural, and even environmental, capital.

From one perfectly reasonable perspective, savings rates are higher today than they have been since the 1950's.

Now mix in the reality that saving can be measured in real or nominal dollar terms, and either gross or net of depreciation in the existing stock of capital. For most economic purposes, it is makes sense to measure saving in real terms and net of depreciation. But "most" doesn't mean "all."

Which measure of saving is most appropriate may well depend on the question. To understand how well households are preparing for retirement, for example, it would be logical to focus on personal wealth measures – ones that include Social Security and Medicare. If the goal is to examine government policies that encourage saving, though, it would be logical to include the effects on government saving as well as on private saving. After all, a policy that increased private saving but led Washington to increase the budget deficit (or reduce the surplus) by an equivalent amount, would have no net impact on saving for the economy as a whole.

Or, if the goal is to understand the share of output that society is devoting to increasing production in the future, it makes sense to include not only conventionally measured saving, but investment in workers' skills, research, and other forms of intangible capital. Whether capital gains should be included may well depend on the source of the gain. Much more on that later.

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A more technical version of this paper may be found in The Brookings Papers on Economic Activity, 1999:1.

THE GOSPEL ON SAVING, ACCORDING TO NIPA

The N.I.P.A. measure of personal saving comes as part of a broader accounting framework whose main purpose is to measure current production and the income generated thereby. Personal saving represents the portion of production made available by households for purchasing new machinery, buildings and the like. The household sector includes families, pension funds, trust funds, non-profits and unincorporated businesses.

N.I.P.A. measures the difference between personal disposable income and personal consumption. Personal income is the sum of wages and other labor income, returns to unincorporated business, other personal income (rents, interest, dividends) and government benefits. Personal disposable income is just personal income less taxes, while the vast bulk of personal consumption consists of outlays for goods and services.

The N.I.P.A. measure is not intended to correspond with what Joe Six-Pack considers saving. First, capital gains are excluded.

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Second, N.I.P.A. treats consumer durables (automobiles, refrigerators, etc.) differently than housing, even though both provide an ongoing stream of consumption benefits. Spending on owner-occupied housing is considered saving, with the imputed rental income included in personal income, and the imputed value of the use of the space in consumption expenditures. By contrast, purchases of other consumer durables count as current consumption.

N.I.P.A. saving includes interest receipts as income and interest payments as outlays. However, in the presence of inflation, economists would argue that only the "real" component of interest should count on either side of the ledger. Thus, if a corporation pays a household $100 in interest on a $1,000 bond and the inflation rate and real interest rate are each 5 percent, N.I.P.A. overstates real household saving by $50 and understates real corporate saving by $50.

Finally, N.I.P.A. counts all pension contributions as saving, even though pensions carry deferred tax liabilities. A household that makes a $100 tax-deductible contribution to a pension and is in the 20 percent tax bracket has actually saved only $80. The remaining $20 is deferred taxes, which represents neither reduced current consumption nor increased future consumption for the household – and thus should not be counted in personal saving.

Corporate saving – a.k.a. retained corporate earnings – is the undistributed profits of corporations plus adjustments for changes in inventory value and capital depreciation. As with personal saving, N.I.P.A. corporate saving does not adjust interest for inflation.

TRENDS IN NIPA SAVING

Enough with the definitions. Table 1 shows N.I.P.A.'s measures of sources of funds for investment for various periods over the last 40 years. And the smoking gun is not hard to spot: personal saving fell from 3.5 percent of GDP in the early 1990's to 0.4 percent in 1998. To mix a metaphor, though, there's not always fire where there's smoke. Table 1 also shows that net private investment increased from 5.3 percent of GDP in 1990-94 to 8.2 percent of GDP in 1998.

That is, the decline in measured personal saving was more than offset by increased saving in other sectors. Total government saving rose from -2.0 percent of GDP in 1990-94 to 2.7 percent in 1998 as chronic budget deficits morphed into towering surpluses. Meanwhile, corporate retained earnings rose by 1.2 percent of GDP and net inflows of foreign saving rose by 1.5 percent of GDP.

Net investment was about 2 percent of GDP lower in 1997-98 than in the 1960's and 1970's. Government saving and retained corporate earnings represented about the same share of GDP in the late 1990's as in the 1960's. But personal saving has fallen by about 5 percent of GDP, while net foreign saving increased by almost 3 percent of GDP.

TWEAKING THE NIPA SAVING MEASURES

It is possible to bring N.I.P.A. estimates closer to theoretical concepts of saving by adjusting the data for a variety of factors. To add durable goods to saving and investment, we use data from the Federal Reserve Board's Flow of Funds accounts. To provide consistent treatment of government and private pensions, we include contributions and interest and dividend earnings to saving – and, to avoid double counting, exclude benefit payments from income in both cases. To adjust saving for inflation, we subtract the product of the percentage change in the inflation rate and the credit-market debt from nominal saving. However, we do not adjust equity

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holdings for inflation, because the N.I.P.A. framework does not include capital gains. To account for deferred taxes in pension saving, we multiply pension-fund saving by an assumed tax rate of 20 percent. For simplicity, we credit the entire revenue to the Federal Government.

The adjusted numbers in Table 2 show the same general trends in the level of national saving as the unadulterated N.I.P.A. data in Table 1. In both, net domestic investment rises in the 1990's, but is below the levels of the 1960's and 1970's. Net domestic investment financed by domestic saving fell from 12.3 percent of GDP in the 1960's to 8.1 percent in 1998, with the gap covered by foreign saving.

But the adjustments do alter the composition of the decline. While N.I.P.A. personal saving declined by 3.1 percent of GDP in the 1990's, adjusted personal saving fell by only 1 percent of GDP. Compared to the 1970's and 1980's, N.I.P.A. personal saving in 1998 had fallen by almost five percentage points, and N.I.P.A. private saving fell by almost four percentage points. Adjusted private saving, however, fell by only 2 percent of GDP.

The inflation adjustment makes a big difference. It reduces net saving of the two creditor sectors (households and foreigners) and raises net saving of the two borrowing sectors (government and corporations). What's more, from the 1970's to 1995 fully five-sixths of the decline in the personal saving rate can be accounted for by the decline in inflation. Likewise, roughly 40 percent of the decline in personal saving from 1995 to 1998 is linked to inflation. Remember, though, that as a matter of definition, the inflation adjustments for Government and corporations on the other side of the ledger cancel out the adjustments on the household side.

Investment in consumer durables was 2.3 percent of GDP in 1998, and increased by about 1 percent of GDP over the decade. Adding durables does not change long-run investment trends very much, however, because the fraction of GDP devoted to durable goods in 1998 is close to its historical average.

Accumulation in government retirement accounts and trust funds is substantial, rising from about 1 percent of GDP in the 1960's to 1.7 percent in 1998. Shifting these funds from the Government to households alters saving

TABLE 1: SOURCES OF INVESTMENT FUNDS

PERCENT OF GDP

	1960-69	1970-79	1980-89	1990-94	1995	1996	1997	1998
NET DOMESTIC INVESTMENT:	10.6%	9.4%	7.8%	5.3%	6.3%	6.9%	7.6%	8.2%
Personal Saving	5.2	5.7	4.8	3.5	2.7	2.2	1.5	0.4
Corporate Retained Earnings	3.6	2.9	2.3	2.4	3.5	3.4	3.7	3.6
Federal Government Surplus	0.3	-1.9	-3.2	-3.4	-2.4	-1.4	-0.3	0.9
State and Local Government Surplus	2.1	2.1	1.9	1.4	1.5	1.6	1.7	1.8
NET SAVING FROM FOREIGNERS	-0.6	-0.2	1.8	1.0	1.4	1.6	1.7	2.5
(STATISTICAL DISCREPANCY)	-0.1	0.7	0.1	0.4	-0.4	-0.4	-0.7	-1.0

SOURCE: National Income and Product Accounts

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in both sectors, but does not change conclusions about the recent drop in personal saving because government pension saving has been stable – or even falling – in the last decade. Adjusting for taxes reduces personal saving by about 1 percent of GDP for the last 30 years, but does not significantly alter the trend.

All told, the adjustments raise the level of saving, reinforce the notion that saving has declined, and shuffle the source of the decline. In particular, official N.I.P.A. personal- and private-saving figures show larger declines than adjusted measures do.

TABLE 2: ADJUSTED MEASURES OF SAVING AND INVESTMENT

PERCENT OF GDP

	1960-69	1970-79	1980-89	1990-94	1995	1996	1997	1998
ADJUSTED NET DOMESTIC INVESTMENT (Includes consumer durables)	12.8%	11.6%	9.8%	6.8%	8.2%	8.9%	9.7%	10.5%
ADJUSTED TOTAL PRIVATE SAVING	10.6	9.0	8.7	7.2	8.0	7.6	7.6	6.9
ADJUSTED PERSONAL SAVING:	6.3	4.1	5.1	3.7	3.8	3.5	3.4	2.9
Equals NIPA Personal Saving	5.2	5.7	4.8	3.5	2.7	2.2	1.5	0.4
Plus Investment in Consumer Durables	2.2	2.2	2.0	1.4	1.9	2.0	2.1	2.3
Plus Saving in Government Retirement and Social Insurance Funds	1.0	0.8	1.9	1.9	1.6	1.4	1.9	1.7
Plus Inflation Adjustment	-1.8	-4.0	-2.6	-2.2	-1.5	-1.2	-1.1	-0.6
Less Deferred Tax Adjustment	-0.4	-0.6	-1.1	-1.0	-0.8	-0.8	-1.0	-0.9
ADJUSTED CORPORATE RETAINED EARNINGS:	4.3	4.9	3.7	3.5	4.2	4.0	4.3	4.0
Equals NIPA Corporate Retained Earnings	3.6	2.9	2.3	2.4	3.5	3.4	3.7	3.6
Plus Inflation Adjustment	0.7	2.0	1.4	1.1	0.7	0.6	0.6	0.3

SAVING ACCORDING TO THE FLOW OF FUNDS ACCOUNTS

When in doubt, more information is better than less. And our second perspective on saving uses data from the Federal Reserve's Flow of Funds Accounts (F.F.A.). The F.F.A. measures wealth and debt at moments in time, along with the acquisition and disposition of assets and liabilities. It does not, however, take capital gains into account.

With minor differences, F.F.A. personal saving is meant to capture the same information as the N.I.P.A. numbers. However, the two use different sources and approaches to tracking saving, which allows us to slice and dice the numbers in different ways.

The F.F.A. saving rates, shown in Table 3, reveal the same decline in saving found in the N.I.P.A. data. F.F.A. private saving fell from an average of 15 percent of income in the 1980's to 9 percent from 1996-98. The equivalent measure of household saving fell from 12.2 percent of expanded disposable income in the 1980's to under 5 percent in 1996-98.

Table 3 breaks net saving into gross saving, gross borrowing and their components. And the numbers reveal a striking fact: The long-run decline in saving is largely linked to a reduction in gross saving – and, within gross saving, in the acquisition of financial assets. Acquisition of financial assets fell from about 13 percent of GDP in the 1980's to just 6 percent in 1996-98.

The importance of borrowing has varied

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over time. In the 1990's, the rise in private borrowing accounts for more than 100 percent of the decline in private saving. But comparing recent years to earlier decades suggests little real change. Borrowing rates in 1995-97 were somewhat lower than in the 1970's and 1980's, and the borrowing rate in 1998 was just 1 percent of GDP higher.

Table 3 also shows how borrowing changes relative to household investment in the tangible assets – notably housing – which most people use as collateral. Investment in housing net of mortgage debt has actually been negative during the last 30 years. Thus, the data do not suggest that increased borrowing has led to the recent decline in saving.

TABLE 3: PRIVATE BORROWING AND SAVING IN THE FLOW OF FUNDS ACCOUNTS

PERCENT OF EXPANDED DISPOSABLE INCOME

	1960-69	1970-79	1980-89	1990-94	1995	1996	1997	1998
HOUSEHOLD AND CORPORATE SECTORS NET SAVING:	17.2%	16.7%	15.2%	12.1%	11.2%	9.8%	9.6%	9.3%
CORPORATE SECTOR NET SAVING	5.0	4.0	3.1	3.2	4.6	4.5	4.8	4.9
HOUSEHOLD SECTOR NET SAVING:	12.2	12.7	12.2	9.0	6.6	5.3	4.8	4.4
EQUALS HOUSEHOLD SECTOR GROSS SAVING:	16.6	19.5	19.1	13.9	13.0	11.8	10.9	12.5
Investment in Owner-occupied Housing	2.5	3.3	3.1	2.8	2.7	2.9	2.2	2.7
Investment in Consumer Durables	3.1	3.0	2.7	1.9	2.5	2.7	2.8	3.1
Investment in Non-profit Tangible Capital	0.9	0.5	-0.1	-0.2	0.2	0.3	0.9	0.8
Net Acquisition of Financial Assets Less Accrued Taxes	10.1	12.7	13.4	9.4	7.7	6.0	5.1	6.0
LESS HOUSEHOLD SECTOR GROSS BORROWING:	4.5	6.8	6.9	4.9	6.5	6.5	6.2	8.0
Mortgage Borrowing	2.4	4.3	4.7	3.4	3.1	4.3	3.9	5.8
Consumer and Other Debt	2.0	2.5	2.2	1.5	3.4	2.2	2.3	2.2

SOURCE: Flow of Funds Accounts

MAYBE THE BABY BOOMERS REALLY ARE WORRIED ABOUT RETIREMENT

Table 4 separates retirement saving – pensions, 401(k)s, I.R.A.'s, Keoghs – from other saving. Pension saving is measured explicitly in the F.F.A., and we use data from a variety of sources to estimate I.R.A. saving.

While Table 3 showed that the decline in saving was fully explained by a decline in acquisitions of financial assets, Table 4 suggests the source can be pinpointed more closely. It will come as no surprise that retirement saving, fueled by the growth of 401(k)s, remained strong throughout the period. Almost all of the saving decline, it seems, occurred in saving outside retirement accounts. Personal saving fell by almost 7 percent of disposable income from the 1970's and 1980's to 1998 – as did households' acquisition of non-retirement financial assets.

Accumulation in private and government pensions have represented relatively stable shares of GDP over the last three decades. I.R.A. saving has not fallen, either, though its tax deductibility was restricted after 1986.

CAPITAL GAINS: THE 800-POUND GORILLA

For all the insights to be had from a careful look at the N.I.P.A. and F.F.A. numbers, nei-

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ther can shed light on the role of capital gains. And given the multi-trillion dollar run-up in stock market values in recent years, that is equivalent to giving a party and forgetting to invite the guest of honor.

Table 5 compares the magnitude of capital gains against measured F.F.A. saving over the past 40 years. Note first that capital gains have dominated conventional saving as a source of wealth change except during the 1960's and all of it. Capital gains on pension assets alone have equaled 10 percent of income since 1995.

"GAINS-INCLUSIVE" SAVING RATES

To examine saving rates that include capital gains, we incorporate capital gains in the F.F.A. saving rates calculated in Tables 3 and 4. The rates of wealth accumulation in Table 6 are noticeably lower than the values in Table 5 because capital gains increases the denomina-

TABLE 4: SAVING IN RETIREMENT AND NON-RETIREMENT VEHICLES

PERCENT OF EXPANDED DISPOSABLE INCOME

	1960-69	1970-79	1980-89	1990-94	1995	1996	1997	1998
HOUSEHOLD AND CORPORATE SECTORS NET SAVING:	17.2%	16.7%	15.2%	12.1%	11.2%	9.8%	9.6%	9.3%
SAVING IN RETIREMENT VEHICLES:	2.0	3.5	5.9	5.2	4.3	4.4	5.3	4.7
Private Pensions	1.3	2.4	2.8	2.5	2.2	1.8	2.4	2.5
Government Pensions	0.7	1.0	1.9	1.6	1.1	1.5	1.6	1.2
Individual Retirement Accounts			1.2	1.0	1.0	1.0	1.3	1.0
SAVING IN NON-RETIREMENT VEHICLES:	15.2	13.2	9.4	7.0	6.9	5.4	4.3	4.6
EQUALS HOUSEHOLD NET ACQUISITION OF NON-RETIREMENT ASSETS:	14.7	16.1	13.2	8.7	8.7	7.5	5.7	7.7
Life Insurance and Trust Assets	1.0	1.3	0.9	0.9	0.9	0.6	2.1	1.5
Other Non-retirement Assets	13.7	14.7	12.4	7.8	7.8	6.9	3.6	6.2
PLUS CORPORATE RETAINED EARNINGS	5.0	4.0	3.1	3.2	4.6	4.5	4.8	4.9
LESS GROSS BORROWING	4.5	6.8	6.9	4.9	6.5	6.5	6.2	8.0

SOURCE: Flow of Funds Accounts

from 1990-94.

Second, the overall rate of capital gains accumulation since 1995 is very large, and will prove even larger when the decline in inflation is taken into consideration. Since 1995, capital gains have accounted for a whopping 80 percent of the increase in household net worth. In 1997 and 1998, capital gains were more than 10 times traditional saving.

Third – no surprise here – the composition of gains has changed. In the 1970's and 1980's tangible capital such as real estate accounted about half of the gain, while in the 1990's financial assets accounted for almost

tor of the fraction significantly – especially in recent years. Nevertheless, the late 1990's still stand out as a period of explosive growth in wealth. The annual change in households' net worth has averaged around 35 percent of "gains-inclusive" income since 1995. This greatly exceeds the rate of accumulation in the 1960's and the early 1990's, and is about the same as the rate in the 1970's and 1980's.

Wait, though: the story gets better. Thus far, the rates have been calculated in terms of nominal dollars. And adjusting for inflation dramatically changes the results.

The real increase in household net worth

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in the 1970's amounted to 13 percent, compared to a 33 percent gain in nominal terms. For the 1960's, 1980's and 1990-94 periods, the annual increases in household net worth are trimmed by about 10 percent when inflation is factored out. But the inflation adjustment for the late 1990's is small. Thus, the inflation-adjusted "gains-inclusive" rates cannot change the long-term fiscal outlook. For attributing the tax accruals to Federal accounts when the accruals occur means that they cannot be attributed again in the future. Nevertheless, an accounting fix that banked taxes on unrealized capital gains when the gains occurred would lead to the conclusion that fiscal policy was not nearly as profligate as it appeared in the 1980's.

TABLE 5: SOURCES OF CHANGE IN HOUSEHOLD SECTOR NET WORTH

PERCENT OF EXPANDED DISPOSABLE INCOME

	1960-69	1970-79	1980-89	1990-94	1995	1996	1997	1998
TOTAL CHANGE IN HOUSEHOLD SECTOR NET WORTH:	27.8%	39.5%	37.1%	17.9%	42.4%	35.8%	51.0%	48.0%
HOUSEHOLD SECTOR NET SAVING	12.2	12.7	12.2	9.0	6.6	5.3	4.8	4.4
CAPITAL GAINS:	15.7	26.8	24.9	8.9	35.8	30.5	46.2	43.6
GAINS ON TANGIBLE ASSETS	4.8	14.7	11.6	0.6	3.1	3.2	6.8	6.5
GAINS ON FINANCIAL ASSETS:	10.8	12.2	13.3	8.3	32.7	27.3	39.4	37.1
Retirement Assets	0.3	0.3	1.9	2.6	10.4	8.7	14.0	13.7
Non-retirement Assets	10.5	11.8	11.4	5.7	22.3	18.6	25.5	23.4

of real wealth accumulation in the late 1990's are higher than at any time in 40 years.

Big capital gains do, of course, imply big tax liabilities down the road. So we adjust accrued capital gains on pensions by 20 percent and accrued capital gains on taxable assets by a plausible 10 percent. Figure 1 shows the fully adjusted saving rates on an annual basis. Once again, the wealth accumulation figures are larger, relative to income, than at any time in the past 40 years.

Note, by the way, that the adjustment for deferred taxes has a significant impact on the time path of the Federal budget surplus. Unpaid taxes on pensions and I.R.A.'s alone have risen by $2 trillion dollars since 1980 – or about half the amount of the Federal debt.

Adjustments for deferred taxes, however,

DO CAPITAL GAINS BELONG IN MEASURED SAVING?

By now it is obvious that interpretations of recent saving behavior hinge on whether capital gains are included. And while it may seem equally obvious that capital gains represent wealth – why else are the streets of Palo Alto and San Jose clogged with BMWs? – it doesn't necessarily follow that the gains should be included in national saving.

Alan Auerbach of the University of California at Berkeley notes that if saving is defined as the creation of resources today with the goal of consuming more tomorrow, then much depends on the source of the gain. If the underlying assets have become more productive, the capital gain should indeed be considered saving. However, if the gain results from, say, a shift in tastes that don't affect fu-

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ture productivity they should not be included.

For example, a decline in the value of a bulldozer linked to its decline in productivity as it wears out clearly should be counted as negative saving. But a decline in value in the old bulldozer due to the invention of a better bulldozer should not count as a fall in saving since the physical productivity of the old machine does not decline.

lead to a different conclusion in an economy open to international investment. If, for example, the Japanese are willing to trade more automobiles for an acre of real estate in Beverly Hills, the gain is real to Americans.

In practice, determining which capital gains fall in which category is difficult. David Bradford of Princeton acknowledges that changes in interest rates could cause changes

TABLE 6: GAINS-INCLUSIVE SAVING RATES

PERCENT

	1960-69	1970-79	1980-89	1990-94	1995	1996	1997	1998
CHANGE IN HOUSEHOLD SECTOR NET WORTH OVER GAINS-INCLUSIVE INCOME	26.0	33.3	32.1	18.6	35.2	30.9	39.1	37.5
Adjusted for Inflation	16.7	13.6	19.6	6.0	30.4	26.2	35.4	35.4
Adjusted for Accrued Taxes	25.3	32.4	30.8	17.1	32.6	28.7	36.4	34.9
Adjusted for Inflation and Accrued Taxes	15.8	12.0	17.9	4.0	27.3	23.6	32.4	32.6
ADDENDUM								
Accrued Tax Liabilities on Household Sector Assets, % of GDP	0.8	1.2	1.7	1.4	4.0	3.1	4.7	4.3
Federal Surplus Adjusted for Accrued Taxes, % of GDP	1.1	-0.7	-1.5	-2.0	1.6	1.6	4.4	5.2

Or suppose each generation owns land as its only store of value, and sells the land to the next generation to finance its retirement. And further suppose that a change in the price of land that occurs because one generation has a different "discount rate" – the rate reflecting how much people must be compensated to consume tomorrow rather than today. Then the land will change in value but not in productivity. And the capital gains on the land will not represent saving for the economy as a whole.

Thus, just because it is appropriate to include capital gains in measuring the wealth of an individual or group does not automatically imply that it is appropriate to include such gains in aggregate wealth.

Auerbach's land example, however, may

in market values. But he concludes, nevertheless, that market value remains a more useful saving concept than the N.I.P.A. measure of wealth. By contrast Charles Schultze of The Brookings Institution suggests that most gains have little to do with increases in future production or income – and thus, as a rule of thumb, should not be counted as saving.

More recently, the journalist James Glassman along with Kevin Hassett of the American Enterprise Institute have taken a different tack. They argue that the recent run-up in stock prices is due in large part to the decline of the "equity risk premium" – the extra return demanded for holding stocks rather than assets like Treasury bills that do not fluctuate in value.

This is more likely to be result of changes

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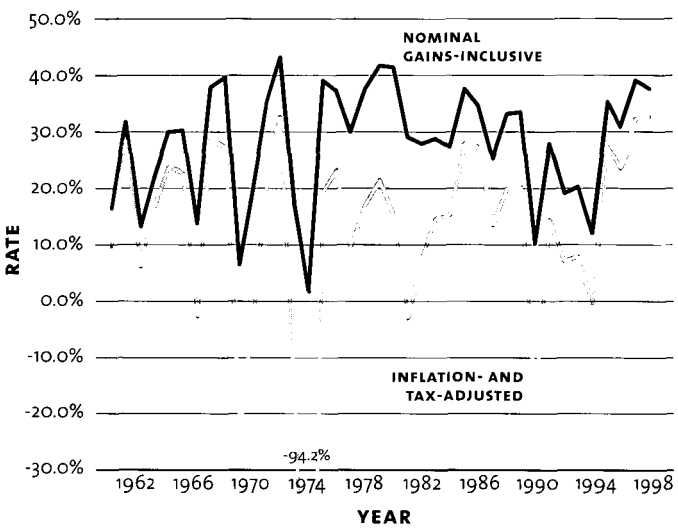
in investors' attitudes toward risk than the result of optimism about the future of corporate earnings or a boundless faith in the so-called "new economy." From this perspective, the run-up in stock prices should be considered an increase in national saving only to the extent that it raises Americans' ability to purchase items from abroad.

However, Robert Hall of Stanford offers an opposing view. His estimates indicate that capital gains on corporate stock can be interpreted as increases in the quantity of capital under certain conditions – notably the absence of monopoly profits. And over time, he says, the aggregate value of corporate securities does more or less move in synch with the quantity of capital.

FIGURE 1: SAVING RATES INCLUDING CAPITAL GAINS



THE LAST WORD

Like others, we believe that official saving statistics poorly reflect basic economics, and that adjusted measures tell a very different story. Set aside the question of how to deal with capital gains. Less controversial adjustments to the N.I.P.A. numbers suggest that adjusted private saving has fallen only modestly since the 1970's – enough to matter, but hardly the catastrophe some infer from the unadjusted data on personal saving.

The adjusted Federal Reserve F.F.A. saving data show a similarly modest decline. They also show that borrowing is not significantly out of line with past decades – and that the bulk of the decline in saving is linked to lower rates of accumulation of non-retirement assets.

Adding capital gains fundamentally changes the trends. With all capital gains included, the household saving rate is the highest it's been in at least the last 40 years. Just how to weigh that finding, though, remains controversial.

Remember, too, that broader definitions of wealth could further alter views about trends in saving. Intangible capital – technology, human capital – may be growing rapidly, but these expenditures are not treated as saving or investment in any of the official stats. Tangible government assets – schools, hospitals, military equipment – generate flows of services that, in theory, must be weighed, too.

We believe that the appropriate measure of saving must remain a judgment call, and – at the risk of repeating ourselves – depends on the question being asked. But that should not be read as call for anarchy: Developing theoretically consistent measures of saving would surely be helpful. ▣

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Heaven's Door:

Immigration Policy and the American Economy

ILLUSTRATIONS BY
SCOTT MENCHIN

Americans have an exceptionally well-honed capacity to think inconsistent thoughts about public policy. Schools, almost everyone agrees, are pretty bad. But the majority thinks the schools *its* kids go to are pretty good. The Federal Government is a parasite, funneling hard-earned wages into useless programs. Except, of course, for Social Security, Medicare and defense, which are extremely popular – and consume the vast bulk of Federal revenues. ¶ So it is with immigration. Immigrants are our parents, who accepted the hardships of starting over to make a better life for their kids. But immigrants are also those sneaky folks from Mexico and Pakistan who are taking jobs away from real Americans. We honor them, fear them – and enjoy the bounty of their labors. ¶ By the same token, George Borjas's new book *Heaven's Gate* (Princeton University Press) is bound to excite contradictory feelings. On the one hand, Borjas, a Cuban-born immigrant who now teaches economics at Harvard's Kennedy School of Government, acknowledges the debt he owes to this country. On the other, he advocates a sober re-examination of an immigration policy that reunites families and keeps the price of all sorts of middle-class services affordable – but reduces the living standards of unskilled natives. ¶ Is Borjas right? That's for you to decide.

BY GEORGE J. BORJAS

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In one sense, this is a very personal book. I am, after all, an immigrant. To be more precise, I am a Cuban refugee. My family – like millions of other families who have found themselves in similar circumstances – benefited immensely from the opportunity to live in the United States, giving us access to political privileges and economic opportunities that most people in the world cannot even imagine. And yet this book will surely be interpreted by some as presenting an unfavorable view of immigrants. Part of the problem is that the immigration debate frames the issues in black and white: one must either be in favor of wide-open borders or of highly restrictive immigration policies. However, as with most things in life, there is a large range of options in varying shades of gray.

The evidence indicates that immigration imparts both benefits and costs on the United States. Yet because the book is not a paean to immigration, I fear that it will be pigeonholed as supporting the position that immigration is inherently harmful and should be greatly curtailed – or even stopped altogether.

I have been thinking about immigration for a long time. In fact, I remember the first quiet rumblings about *emigracion* soon after Fidel Castro's tanks rolled into Havana. I was 8 years old. My family had been part of the entrepreneurial class in prerevolutionary Cuba, owning a small factory that manufactured men's pants. The entire family worked at the factory, and it employed an additional 30 or so employees. Although we lived a comfortable life, the scale of the operation was too small to allow us to accumulate much wealth – let alone transfer it out of the country in the pre-Castro days. At the same time, however, the factory was too threatening for the ideologues opposed to entrepreneurship and individual incentives. A year or so after Castro's arrival, the factory was confiscated, and my family's means of support suddenly disappeared.

I remember the gatherings where my family discussed emigrating to the United States. I listened attentively as my relatives talked in hushed voices about the mechanics and difficulties of getting a "green card," as the magical piece of paper that permits a person to live permanently in the United States is commonly known.

Those conversations, of course, were entirely in Spanish, and it was then that I first heard about *la residencia* – the Cuban slang for this permit. I began to daydream about the Hollywood lifestyle that America entitled a person to. My *residencia* in Miami would surely have dozens of rooms, a swimming pool and beautifully landscaped grounds.

My father died just before the Bay of Pigs fiasco, and it wasn't until after his death that my mother began the paperwork required to leave the country. Her efforts, along with the generous assistance of the Catholic priests who had taught me in school in prerevolutionary days, finally paid off on the morning of Oct. 17, 1962. That was just a week before the Cuban missile crisis and the permanent shutdown of the "freedom flights" that had

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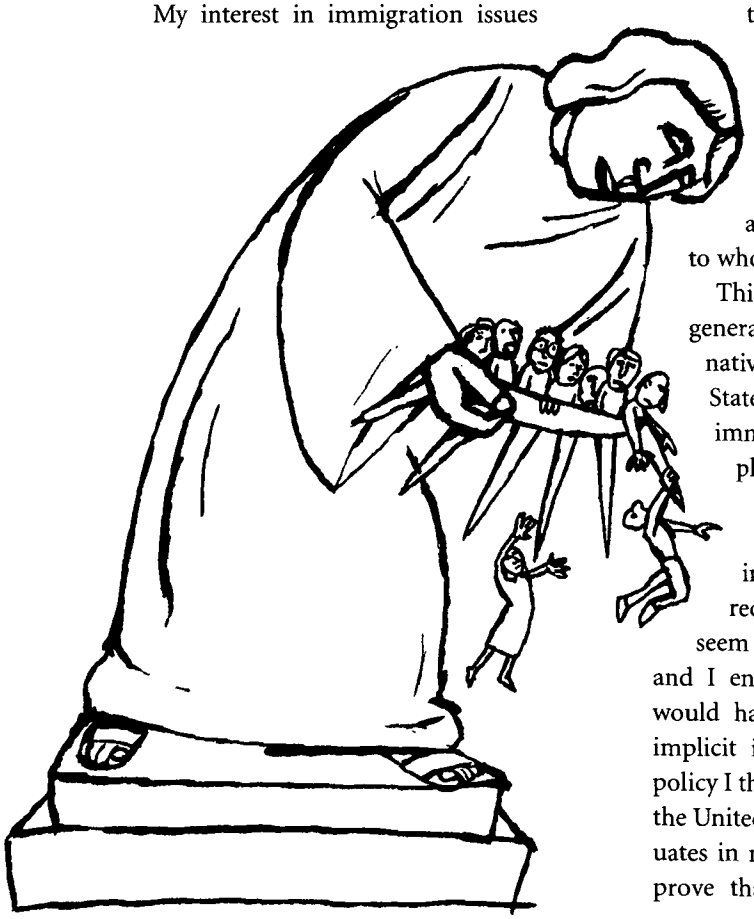
carried thousands of Cubans to a new life in the United States.

We boarded a Pan Am propeller plane and landed in Miami an hour later. Although it is less than 200 miles from Havana to Miami, it immediately struck me that the two places were polar opposites. Havana was dead; nothing was possible because the prison walls surrounded everything and everyone. Miami was alive!

To this day, I am amazed by the courage and boldness that my mother and millions of others exhibited in picking up the little they had and starting life again in a foreign country. And I have often wondered whether I would have been as courageous if I had faced similar circumstances.

My interest in immigration issues has continued through the years – in college, where I carried out a survey of immigrant households for a sociology class; in graduate school, where my doctoral dissertation addressed issues related to labor mobility, and throughout much of my professional career, a large chunk of which I spent in California, the hot zone of modern immigration.



I learned how to be an economist at Columbia University and the University of Chicago and began my professional study of immigration issues with a strong "Chicago school" perspective. Because free-market solutions are generally hard to beat, it seemed eminently sensible that the United States should place as few restrictions as possible on immigration. But I have to admit that my thinking on this issue has changed substantially over the years. I began to appreciate that the immigrants and the native population of the United States might not have the same interests and, as a result, one had to make a choice as to who mattered more.

This book stresses that immigration generates both costs and benefits for the native-born population of the United States. Thus, the economic impact of immigration will vary by time and by place and can be either beneficial or harmful.

I am fully aware that my own immigrant experience and the policy recommendations contained here may seem incompatible. Although my family and I entered the country as refugees, we would have been unable to pass the tests implicit in the skills-oriented immigration policy I think would best serve the interests of the United States. There were no college graduates in my family, no reserves of wealth to prove that we would not become public

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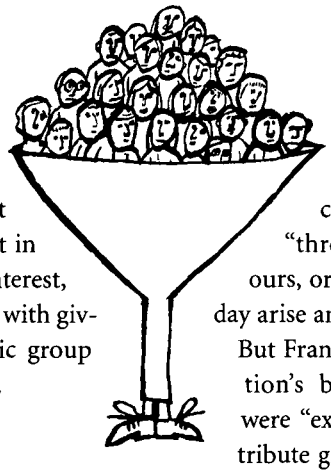
charges, no particular skills that would seem "urgently needed."

Nevertheless, I believe that immigration policy should be set in ways that further the national interest, and this may simply not coincide with giving a particular person or ethnic group the opportunities America offers.



REFRAMING THE IMMIGRATION DEBATE

In January 1979, China's Vice Premier, Deng Xiaoping, made a state visit to Washington. At one of his meetings with President Jimmy Carter, the President began his standard lecture, stressing that China had to learn to respect human rights. Like most communist countries, China made it extremely difficult for its citizens to leave – presumably because none should ever want to leave a workers' paradise.

"Mr. Vice Premier," the President said, "the Jackson-Vanik amendment prohibits our granting 'most-favored nation' status to centrally managed economies, unless they provide freedom of departure for their own nationals." Deng Xiaoping leaned back in his chair, smiled and asked, "Well, Mr. President, how many Chinese nationals do you want? Ten million? Twenty million? Thirty million?"

There, in an ironic nutshell, is what the immigration debate is all about. Since there are many more persons who want to migrate to the United States than the country is willing to admit, whom should the country accept?

This debate has raged throughout American history. Twenty-three years before he signed the Declaration of Independence, Benjamin Franklin ruminated at length about the costs and benefits of German immigration. On the one hand, he wrote, German immigrants are "the most stupid of their own nation. Few of their children in the country know English," and "through their indiscretion, or ours, or both, great disorders may one day arise among us."

But Franklin also appreciated immigration's benefits: German immigrants were "excellent husbandmen and contribute greatly to the improvement of a country." In the end, Franklin concluded, the benefits could outweigh the costs. "All that seems necessary is, to distribute them more equally, mix them with the English, establish English schools where they are now too thick settled."

American history is littered with such calculations. In some periods, they encourage an open-door immigration policy – as was the case until 1924. In others, they tempt the country to close the door – as was the case from 1924 through 1965.

As the 21st century begins, the United States is about to embark once again upon an uneasy debate about immigration policy. And again, an implicit cost-benefit calculus frames it: Who loses from immigration and by how much? Who gains and by how much?

Consider the possible costs. There is a great deal of worry that immigrants make extensive use of social services and do not pay their way in the welfare state. There is also anxiety that competition with immigrants harms American workers. And there is another traditional concern: Will today's immigrants find it harder to assimilate than earlier waves did? Will the presence of hard-to-assimilate immigrants further balkanize the country, with undesirable social, economic and political consequences?

On the benefit side, it is sometime argued that immigration spurs economic growth by

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contributing to new industries – think Silicon Valley. Immigrants reintroduce ambition and drive into the economy, helping to propel the country forward. The large-scale migration of less-skilled workers may also reduce the prices that Americans pay for goods and services. By the same token, some industries – such as California agriculture – would very likely disappear if immigrant labor were not available. In short, the size of the economic pie may be greatly increased by immigration.

SOME STYLIZED FACTS OF IMMIGRATION

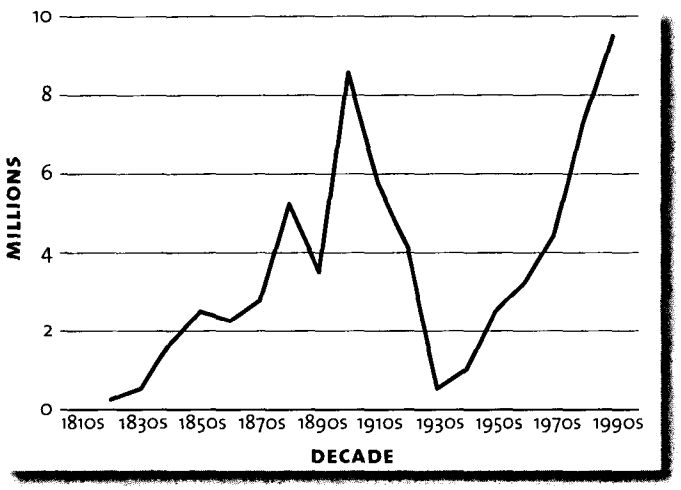
The Number of Immigrants Entering the United States is at Record Levels. Although the United States has admitted immigrants throughout its history, the numbers have fluctuated greatly. Eras of heavy migration were followed by decades of rest, during which successive waves were assimilated into the American mainstream.

Surprisingly few immigrants – about 10 million – entered the country between 1820 and 1880. The huge flow that has come to be known as the Great Migration began around 1880 and continued until 1924, bringing 26 million immigrants. Between 1901 and 1910, at the peak of this unprecedented migration, an average of 900,000 arrived each year.

Restrictions imposed in 1924 and reinforced during the Great Depression reduced the flow to a trickle by the 1930's. Since then the number of immigrants has risen, with the pace accelerating in the 1970's and 1980's. By the late 1990's, nearly one million persons were entering the country legally each year, and another 300,000 were coming illegally.

The number coming today is at record levels. The country, however, is much larger now than it was in the early 1900's. As a result, advocates of liberal immigration emphasize that the foreign-born share of the United States population is much lower now – implying that immigration is not as serious an issue as others make it out to be. In 1910, 15 percent of the population was foreign-born, compared with 10 percent in 1998. It is worth noting, however, that the foreign-born share of the population has doubled since 1970.

NUMBER OF LEGAL IMMIGRANTS



Moreover, it is not clear that this spin on the data accurately describes the demographic impact. Because of the increasing number of immigrants and the lower fertility rate of American women, immigration in the 1990's (as in the early 1900's) accounted for at least a third of the growth in population. This clearly justifies calling the large immigrant wave that began after 1965 the Second Great Migration.

The Relative Skills and Economic Performance of Immigrants Have Declined. In 1960, the average immigrant male earned about 4 percent more than his native

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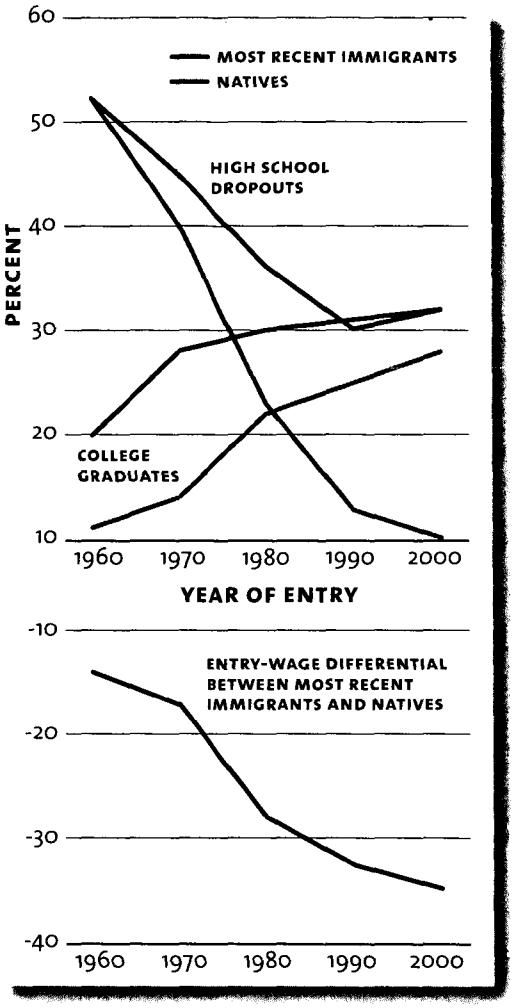
THE CHANGING SKILLS OF SUCCESSIVE IMMIGRANT WAVES



counterpart. By 1998, the average immigrant earned about 23 percent less.

The worsening economic performance of immigrants is partly attributable to a decline in their relative skills. Immigrants in 1960 were better educated at their time of arrival than natives; by 1998 the newest immigrants averaged almost two fewer years of schooling. Not surprisingly, the relative wage of successive immigrant waves also fell.

On entry, immigrants have traditionally received lower wages than their native counterparts. Nonetheless, the relative decline is striking: the newest immigrants in 1960 earned 13 percent less than natives; by 1998, the newest immigrants earned 34 percent less. This relative decline in immigrants' skills helped rekindle the debate over immigration policy and is the source of many irritants that have surfaced.

Not every new immigrant fits this description: Immigrants tend to cluster at both ends of the skill distribution. But the bump at the bottom has become much more pronounced. By the late 1990's, almost 40 percent of the immigrants were in the bottom fifth of the native wage distribution, and only 14 percent were in the top fifth.

Immigrant Earnings Will Continue to Lag. The worsening economic performance of new immigrants might not be a cause for concern if their disadvantage diminished as they assimilated. However, the economic gap between immigrants and natives does not narrow substantially during the immigrants' working lives.

Judging from the past, economic assimilation – the acquisition of skills that employers value, such as English language proficiency – narrows the wage gap between immigrants and natives by about 10 percentage points in the first two decades after arrival. Immigrants who entered the United States after 1980 had a 25 percent wage disadvantage at the time of entry. Thus, if these recent arrivals experience the same rate of economic assimilation as earlier waves, the wage gap between recent immigrants and natives will remain above 15 percent through much of their lives.

National Origin Matters. The increase in immigration in recent decades is in part caused by changes in United States policy. Before 1965, immigration was guided by national origin quotas that allocated most

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visas to people from Western Europe – particularly Britain and Germany. The 1965 amendments to the Immigration and Nationality Act (and subsequent revisions) repealed the national origin restrictions, increased the number of visas and made family ties to persons already living in the United States the key to determining who can enter.

As a consequence of these shifts as well as major changes in economic and political conditions in the "source" countries, the national origin mix changed radically. Two-thirds of the legal immigrants admitted during the 1950's came from Europe and Canada, one-quarter from Latin America and only 6 percent from Asia. By the 1990's, just 17 percent came from Europe and Canada, while almost half were from Latin America and 30 percent were from Asia.

These changes have generated great concern about the ethnic and racial composition of the population. In 1970, 5 percent of Americans were Hispanic, 1 percent Asian and 12 percent black. By the year 2050 the population is projected to be 26 percent Hispanic, 8 percent Asian and 14 percent black. If nothing else, the Second Great Migration has altered the "look" of Americans in ways unimaginable in 1970.

There are also huge differences in economic performance among national origin groups. Immigrants from El Salvador and Mexico earn 40 percent less than natives, while those from Australia and South Africa earn at least 30 percent more. These differences mirror the dispersion in skills across the populations of the source countries. Immigrants from countries that have abundant human capital and high average incomes tend to do better in the United States.

In view of the sizable skill differences across ethnic groups, it is not surprising that the changes induced by the 1965 amendments explain the decline in the economic performance of successive immigrant waves. Put differently, there would not have been a decline in the relative skills and earnings of immigrants if the national origin mix of immigrants had remained the same.

SOURCE OF LEGAL IMMIGRATION TO THE UNITED STATES

	PERCENT DISTRIBUTION		
COUNTRY OF BIRTH	1951-60	1971-80	1991-96
EUROPE	**52.7**	**17.8**	**14.5**
Germany	19.0	1.7	14.5
Greece	1.9	1.7	0.1
Ireland	1.9	0.3	0.9
Italy	7.4	2.9	0.2
Poland	0.4	0.8	2.1
United Kingdom	8.1	3.1	1.5
ASIA	**6.1**	**35.3**	**31.8**
China	0.4	2.8	4.4
India	0.1	3.7	3.9
Iran	1.0	1.0	1.3
Korea	0.2	6.0	1.9
Philippines	0.8	7.9	5.7
Vietnam	0.0	3.8	5.2
AMERICAS	**39.6**	**44.1**	**50.2**
Canada	15.0	3.8	1.5
Mexico	11.9	14.3	26.9
Cuba	3.1	5.9	1.5
Dominican Republic	0.4	3.3	4.2
Haiti	0.2	1.3	1.9
AFRICA	**0.6**	**1.8**	**3.4**
AUSTRALIA	**0.5**	**0.9**	**0.5**

This raises an important – and disturbing – issue. Because national origin and immigrant skills are so closely related, any attempt to change one will inevitably change the other.

Immigration Harmed the Economic Opportunities of the Least-Skilled Natives. Immigrants tend to cluster in a small number of cities and states. In 1998, almost three-quarters lived in six states (California, New York, Texas, Florida, New Jersey and Illinois), while only a third of the native-born lived in those states.

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EDUCATION AND WAGES OF IMMIGRANT MEN IN 1990

COUNTRY OF BIRTH	YEARS OF SCHOOLING	PERCENT WAGE DIFFERENTIAL BETWEEN IMMIGRANTS AND NATIVES
EUROPE		
Germany	13.9	24.5
Greece	11.8	-0.9
Italy	10.9	16.1
Poland	12.8	-0.3
Portugal	8.3	-3.1
U. S. S. R.	14.2	6.2
United Kingdom	14.6	37.2
ASIA		
Cambodia	10.2	-30.8
China	12.8	-21.3
India	15.9	17.6
Korea	14.3	-12.0
Laos	10.0	-32.4
Philippines	14.1	-5.9
Vietnam	12.3	-18.9
AMERICAS		
Canada	13.8	24.0
Cuba	11.7	-15.3
Dominican Republic	10.3	-29.2
El Salvador	8.6	-39.7
Haiti	11.2	-30.2
Jamaica	12.0	-11.2
Mexico	7.6	-39.5
AFRICA		
Egypt	15.6	12.2
Ethiopia	14.0	-21.0
Nigeria	15.8	-18.9
AUSTRALIA	15.2	33.0
NATIVE-BORN WORKERS	**13.2**	—

It is tempting to estimate the impact of immigration on native workers by comparing the wages of natives in cities with large numbers of immigrants (such as San Diego) with those of natives who reside in cities with few immigrants (such as Pittsburgh). These "spatial correlations" are, in fact, extremely weak. If one city has 10 percent more immigrants than another, the native wage in the city with more immigrants is just two-tenths of 1 percent lower.

However, it does not necessarily follow that immigrants have an inconsequential impact on the earnings of natives. Suppose, for example, that immigration into California lowers the earnings of natives in California substantially. Native workers are not likely to stand idly by and watch their economic opportunities evaporate. Many will leave California, and workers who were considering moving to California will move somewhere else. Native population flows diffuse the adverse impact of immigration on California over the entire economy. Thus, native workers in all parts of the country are made worse off by immigration – not simply those who live where immigrants cluster.

Between 1980 and 1995, immigration increased the number of workers without high school diplomas by 21 percent, while increasing the number with at least a high school diploma by only 4 percent. During that time, the wage of high school dropouts relative to that of more educated workers fell by 11 percentage points.

The disproportionate increase in workers at the bottom of the skill distribution probably caused half this observed drop. Thus, immigration seems to have been an important contributor to the rise in income inequality in the United States, depressing the economic opportunities of the least skilled.

Immigration Had a Severe Fiscal Impact on the Affected States. In 1970, immigrants were slightly less likely to receive public assistance than natives. By 1998, they had a much higher chance of receiving welfare: Almost a quarter of immigrant households received some type of assistance, compared to 15 percent of native households.

Two distinct factors account for this reversal. Because more recent immigrant waves are less skilled than earlier ones, it is not surprising that more recent immigrants are also

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more likely to use welfare. What's more, the use of public assistance by immigrants increases over time. It seems that assimilation involves learning not only about labor market opportunities but also about the opportunities provided by the welfare state.

This trend, as well as the expense of providing immigrants with a host of public services – particularly education – has added a new and potentially explosive question to the immigration debate: do immigrants pay their way? A study by the National Academy of Sciences concluded that immigration in fact raised the taxes of the typical native household in California by about $1,200 per year.

The welfare reform legislation enacted in 1996 gives states greater leeway in setting benefits. States receiving a high number of immigrants, such as California, have a huge incentive to join the race to the bottom as they attempt to shed the fiscal burden imposed by less-skilled workers.

The (Measurable) Economic Gains from Immigration Are Small. To see how natives gain from immigration, think about how the United States gains from foreign trade. When the United States imports toys made by low-wage Chinese labor, workers in the American toy industry suffer wage cuts and perhaps lose their jobs. These losses, however, are more than offset in dollar terms by the benefits to consumers who buy toys at lower prices.

By the same token, immigrants increase the number of workers. Because of the additional competition in the labor market, the wages of natives fall. At the same time, however, native-owned companies gain because they can now hire workers at lower wages. And many native consumers gain because lower labor costs lead to lower prices. As with foreign trade, the gains accruing to the persons who consume immigrant services exceed the losses suffered by native workers. Hence, society as a whole is better off.

WELFARE USE
BY TYPE OF HOUSEHOLD, 1998

PERCENT RECEIVING SOME SORT OF ASSISTANCE

	NATIVES	IMMIGRANTS
ALL HOUSEHOLDS	15.4	22.4
Refugee households	—	28.5
Nonrefugee households	—	21.4
Households that do not contain any persons over age 65	15.5	20.6
Nonrefugee households that do not contain any persons over age 65	—	20.2

Although some claim that these gains from immigration are large, the facts are quite different. The annual net gain is a modest one-tenth of a percent of gross domestic product. In recent years this amounted to less than $30 per person.

Immigration does more, however, than just increase the total income of natives. It also redistributes wealth away from workers who compete with immigrants and toward employers and other users of immigrant services. Workers lose – and employers gain – because immigrants drag wages down. The income transfers probably amount to tens of billions of dollars a year.

This suggests a different prism for viewing the immigration debate. Immigration works as an income redistribution program, a transfer from those who compete with immigrant workers to those who use immigrant services. The central issue in the debate over immigration policy, therefore, is not whether immigration increases the size of the economic pie. Rather, it is about how the pie is split.

Immigration may also benefit or harm the United States through what economists call externalities. Immigration can introduce new interactions among workers and companies,

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and expose Americans to a variety of new products, such as ethnic cuisine. These benefits, however, are tempered by increased urban congestion and by a greater risk of ethnic conflict. Most externalities, moreover, are hard to measure, and the benefit or harm will often be in the eye of the beholder.

Ethnic Skill Differentials May Persist for Three Generations. In 1998, 11 percent of the United States population was "second generation" – born in the United States but with at least one foreign-born parent. By the year 2050, second-generation citizens will probably increase to 14 percent of the total population, and an additional 9 percent will be composed of the grandchildren of current immigrants. The economic impact of immigration thus depends not only on how immigrants adapt, but also on the adjustment of their offspring.

The experience of the children and grandchildren of the First Great Migration provides important lessons about the long-run consequences of immigration. That migration introduced substantial ethnic skill differentials into the United States: 97 percent of French immigrants knew how to read and write some language, as compared with 80 percent of Greek immigrants and 45 percent of Mexican immigrants.

These differences helped determine the economic performance of their children and grandchildren. A 20 percentage-point difference in literacy rates among two immigrant groups in 1910, for instance, led to a one-year difference in educational attainment in the second generation and a half-year difference in educational attainment in the third. Similarly, a 20-percent wage differential between two immigrant groups in 1910 led to a 12-percent wage differential in the second generation and a 5-percent wage differential in the third. About half of the average skill differential between any two groups in the first generation persists into the second, and half of the remaining differential persists into the third.

The lesson is clear: Skill differentials among today's immigrants lead to skill differentials in tomorrow's ethnic groups. If history is any guide, national origin will indirectly determine the economic performance of the grandchildren of the Second Great Migration at the end of the 21st century. In short, ethnicity matters in economic life, and it matters for a very long time.

Ethnic Spillovers Influence the Social Mobility of Immigrants. The ethnic environment, which I call ethnic capital, influences the economic performance of children beyond the influence of their parents. Ethnic capital includes the culture, attitudes and economic opportunities nurtured by ethnic networks.

Ethnic capital reduces social mobility, making it less likely persons in disadvantaged ethnic groups will move up – and less likely persons in the advantaged ethnic groups will move down. Skill differences across ethnic groups persist across generations because continued exposure to local culture spills over and influences one's life choices.

Thus, the skills of the second generation are affected not only by their parents' skills, but also by the group's mean education and wage. In fact, the impact of ethnic capital on social mobility may account for half of the persistence in skill differentials across generations.

Ethnic Ghettos Incubate Ethnic Differences and Slow Down the Melting Pot. The segregation of young African-Americans helped create the black underclass by depriving young people of positive role models and limiting their contact with economic opportunities. By the same token, the segregation of blacks

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in poor neighborhoods feeds a vicious cycle that makes it all the more difficult to escape the ghetto.

There is also a great deal of residential segregation among other ethnic groups. Mexican-Americans live near other Mexican-Americans, Italian-Americans live near other Italian-Americans, and so on. Because few members of disadvantaged ethnic groups can afford to move, ethnic capital helps to perpetuate socioeconomic differences from generation to generation.

THE GOALS OF IMMIGRATION POLICY

The Statue of Liberty originally had nothing to do with immigration – the French gave it to the American people as a representation of "Liberty Enlightening the World." The symbol changed, however, once a plaque engraved with Emma Lazarus's poem "The New Colossus" was attached to a wall inside the pedestal. Her call for "the huddled masses" and "the wretched refuse" transformed Miss Liberty into a shining beacon for migrants from around the world.

But many more people want to come to the United States than the country has been willing to allow. In November 1998, for example, the State Department was processing visa applications filed 20 years earlier by Filipino-born United States citizens who wanted to sponsor their siblings. These long queues, moreover, probably underrepresent the demand for entry visas. Millions more do not bother to apply because they know they cannot qualify under current regulations.

Consider the "diversity" lottery that the United States held annually in the 1990's. Each year, some visas were made available to persons originating in "countries with low rates of immigration to the United States." The 1997 lottery drew 3.4 million applications for the 50,000 available visas.

Few serious participants in the immigration debate advocate unregulated borders as the solution to this imbalance between the supply of entry visas and the demand. For almost everyone acknowledges that immigration policy must discriminate – I use the word in the old-fashioned sense of using good judgment – to allocate entry visas.

These rules for discrimination may stress family ties (as is currently done) or national origin (as used to be done) or socioeconomic characteristics (as is done in other countries). It is useful to think of immigration policy as creating a formula that gives "points" to visa applicants on the basis of various characteristics and then sets a passing grade.

RESIDENTIAL SEGREGATION FOR SELECTED ETHNIC GROUPS, 1979

ETHNIC ANCESTRY	ETHNIC GROUP'S SHARE OF THE POPULATION	PERCENT LIVING IN "ETHNIC" NEIGHBORHOOD
Black	14.9	79.4
Cuban	0.4	66.7
English	18.9	22.1
Filipino	0. 4	20.5
German	17.4	28.4
Irish	11.0	18.7
Italian	6.2	49.6
Mexican	4.2	83.8
Other Hispanic	0.9	52.3
Polish	3.1	43.0
Portuguese	0.6	66.0
Puerto Rican	1.2	80.2
Russian	0.6	10.6
Scottish	1.5	35.2
ALL GROUPS	—	**48.0**

Since 1965 the formula has, for the most part, had only one variable: whether the applicant has a family member already residing in the United States. The post-1965 policy does not set strict restrictions on the number of immigrants. There are "pierceable caps" – numerical caps that are not really caps because they allow the number of visas to

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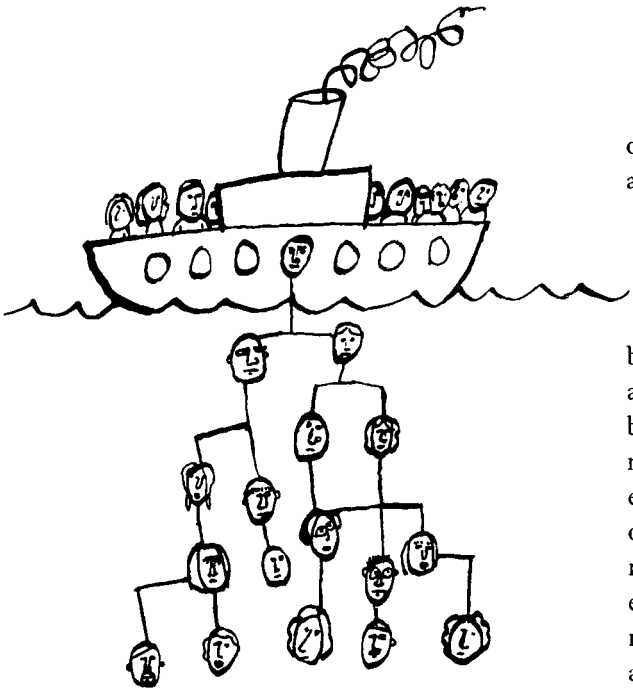

expand with demand.

Admittedly, this is an overly simple summary of current policy. There are a lot of bells and whistles that make the immigration statutes almost as complicated as the Federal tax code and feed an army of immigration lawyers. Current policy, for instance, awards different numbers of points to applicants depending on whether the sponsor is a United States citizen or a permanent resident, on whether the family connection is close (a parent, spouse or child) or more distant (a sibling).

These nuances help determine the alacrity with which the visa is granted, with closer family connections leading to speedier entry. In addition, a limited number of visas are distributed on the basis of skills, but these select workers made up only 7 percent of immigrants in the early 1990's.

Although the United States does not admit to using a point system, other countries proudly advertise them. Canada, Australia and New Zealand use more complex formulas than the United States – formulas that include the applicant's educational background, occupation, English-language proficiency and age, as well as family connections.

New Zealand's policy seems the most creative, using financial incentives to speed assimilation. New Zealand requires the "principal" immigrant in the household be proficient in the English language but allows this principal to bring in family members who are not. A family member who cannot pass the "English standard" at the time of entry has to post a bond of U.S.$11,000. If he or she passes an English test within three months of arrival, the entire bond is refunded. If he or she fails this test at the three-month point but passes it within a year after arrival, the government refunds 80 percent.

Some countries "sell" visas. The United States allocates 10,000 entry visas annually for wealthy foreigners willing to create at least 10 full-time jobs in the United States by investing $1 million. The "price" is reduced to $500,000 if the investment is made in a high unemployment area. Think of the scheme as a system that allows immigrants to buy the requisite number of points for entry.

It seems, however, that the United States has set its admission price too high. In 1996, only 936 such visas (out of 10,000 available) were sold. Competition may explain the shortfall: Canada sells the entry visa for an investment commitment of just U.S. $160,000.

Some people, particularly economists, would support an open market for visas – not just those sold under the investor program. If bread and butter can be traded in the open market, why not green cards?

A free market for visas would insure that those persons who most value the visas would get them. The visa market would thus maximize the combined gains accruing to those who immigrate and to the United States Treasury.

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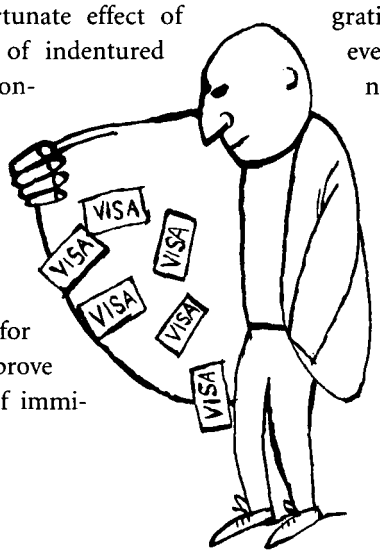
This market approach would solve a lot of the problems. It would create an impartial way to distribute the scarce entry visas. It would generate revenue for the government. And it would filter the applicant pool to insure that only those who valued entry the most would get into the country.

Selling visas, however, raises a number of problems. Many people would never be able to accumulate enough money to bid successfully in this marketplace. Indeed, most of our ancestors would have been unable to buy entry. Income in many developing countries is so low that most visa applicants would have to work several lifetimes to afford one.

This concern is serious, but not insurmountable. The price could be set as a percentage of the source country's average income. Suppose, for instance, that the United States set the price at twice the level of per capita G.D.P. This would mean French immigrants would pay $53,000 for a visa, while Filipinos paid only $2,000.

A more serious problem with an open market for visas is that it would not necessarily increase the skill level of the immigrant population. American employers who have much to gain from an increase in the number of less-skilled workers could help to finance immigrants with loans.

An open market for visas, therefore, might have the unfortunate effect of reintroducing a form of indentured servitude. But such contracts already exist informally between immigrants and their sponsors. By bringing them into the open and regulating them, an open market for visas might actually improve the living conditions of immigrants as they pay off the loans.



There would still be reasons to be concerned about the impact of immigration on less-skilled native workers and on expenditures for social services. However, the market could, in theory, handle these concerns. Before announcing the price for a visa, the government could calculate the net cost of admitting immigrants, including expenditures on public assistance programs and education, tax revenues, wage reductions suffered by native workers and so on. Washington would then set a price that reflected the net cost. And the revenue from selling visas could be redistributed to adversely affected workers and to the taxpayers who would bear the added fiscal burden.

Yet, despite the logical appeal and apparent benefits, the market approach does not seem to go far in the political debate. And for obvious reasons.

A free market for visas would bring a number of difficult moral issues into the open. Many persons (including me) feel that some things – life, liberty – should not be for sale. Similarly, the hard-fought rights granted by American citizenship should not be peddled in the market.

WHAT DO AMERICANS WANT?

It is quite difficult to figure out what immigration policy is in the national interest, even when one focuses solely on economic issues. For any immigration policy will leave both winners and losers, domestic and foreign, in its wake. The country has to decide whose well-being counts most. And in my view, although seldom saying so explicitly, most people think the United States should be concerned only with the economic well-being of the native

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population.

Saying that the United States should design an immigration policy that benefits natives does not necessarily imply that natives are oblivious to what happens in other countries. For instance, the well-being of natives depends on having friendly neighbors. If Mexico were to become unfriendly, the cost of controlling the southern border would probably be far greater than the cost of admitting millions of less-skilled Mexican immigrants.

By admitting these immigrants, the United States gives Mexico a safety valve that relieves social and economic pressures. In the end, the United States should admit Mexican immigrants because it is in the narrow interests of American natives to do so.

By proposing that the country's welfare depends only on the well-being of the native population, it might seem that I am ignoring a basic lesson of American history. The United States, after all, is a nation of immigrants.

But throughout much of the past two centuries, the persons who inhabited America found it beneficial to open the borders. The land had to be tamed, the frontier had to be conquered and the railroads had to be built. This required far more labor than the small population of the young country could provide. So admitting the tired and the poor, though a noble gesture, also coincided with the selfish interests of natives. One can thus interpret the symbolism of the Statue of Liberty in a more cynical way: Give me your tired and your poor, *when the country needs them.*

Efficiency Versus Equity. Even if the country's social welfare depends only on the economic outcomes for the native population, there is one additional question to address. Which dimension of well-being matters most: average income or the distribution of income? Immigration may raise the income of natives, but this does not mean all natives gain equally. Any evaluation of the impact of policy, therefore, must take into account both the size of the economic pie and how the pie is divided.

The evidence suggests that the net gains from immigration tend to be small, so it is doubtful these gains should determine the direction of immigration policy. The truly important economic impact is the change in the division of the pie. The immigration of less-skilled workers redistributes wealth from unskilled to skilled natives, from workers to owners of companies and from taxpayers who bear the burden of paying for the social services used by immigrants to consumers who use the goods and services produced by immigrants.

The political debate over whom to admit is thus best viewed as a tug-of-war between winners and losers. And this fact goes a long way toward explaining why some Americans favor the continued entry of large numbers of immigrants, while others favor a cutoff. Nonetheless, economists usually rank policy alternatives in terms of their effect on total income, with policies that lead to larger increases being considered better, regardless of who gets what.

One can rationalize this approach: A larger economic pie makes it possible to redistribute sufficient income from the winners to make everyone better off. But such redistribution seldom takes place. Those who gain from immigration typically keep the bulk of the gains, while those who lose are left to make do.

There is no objective way of determining what is most important to the nation's social welfare: efficiency or distribution. But in ignoring the fact that every policy change makes some people better off at the expense

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of others, one misses the point of the political debate.

A PROPOSAL FOR AN IMMIGRATION POLICY

Throughout the 1980's and 1990's, the United States annually admitted an average of 730,000 legal immigrants, 100,000 refugees and at least 200,000 illegal aliens. Many were relatively unskilled.

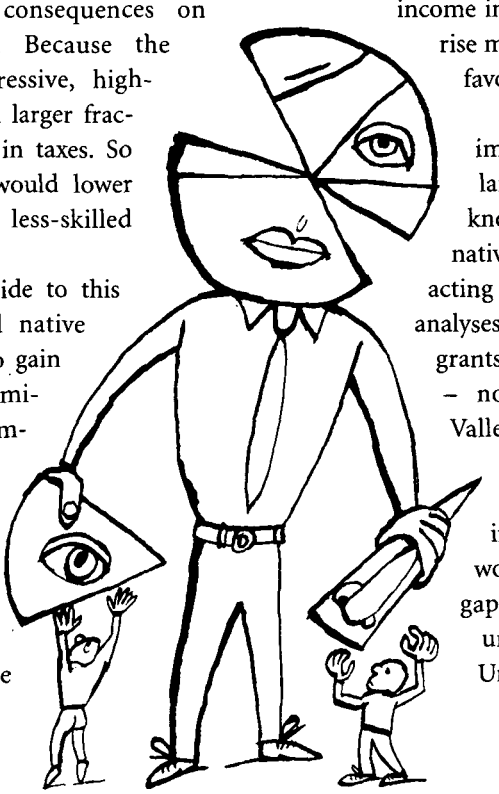
A strong case can be made that the social welfare of the United States would increase if the country adopted a policy favoring the entry of skilled workers. Consider first how the fiscal impact of immigration affects natives. Skilled immigrants earn more, pay higher taxes and require fewer social services than less-skilled immigrants. Thus, skilled immigration increases the after-tax income of natives, while the tax burden imposed by the immigration of less-skilled workers probably reduces natives' incomes.

The fiscal impact of skilled immigration also has desirable consequences on income distribution. Because the income tax is progressive, high-income workers pay a larger fraction of their income in taxes. So skilled immigration would lower the tax burden on less-skilled natives.

There is another side to this coin, though. Skilled native workers have much to gain from less-skilled immigrants. Immigrants complement the productivity of the native work force by taking on a variety of unwanted service jobs. Therefore, it would seem that the typical American worker would gain from unskilled immigration.

But that is not the end of the story. Immigration also affects the profits of native-owned firms. Companies that use less-skilled workers in production gain from the immigration of the less skilled. Other concerns, however, might be better off with skilled immigrants. In fact, studies suggest there is more "complementarity" between skilled labor and capital than between unskilled labor and capital. In other words, the machines now used become more productive when combined with skilled workers than with unskilled ones. Most companies, therefore, have more to gain from skilled immigrants.

In short, there is a conflict between the type of immigrant that the typical (relatively skilled) native worker favors and the type of immigrant that the typical company favors. But because the productivity of capital is very sensitive to inputs of skilled workers, total income in the United States would rise most if immigration policy favored the skilled.



The gains from skilled immigration can be even larger if immigrants bring knowledge and abilities that natives can pick up by interacting with immigrants. In fact, analyses of the impact of immigrants on particular industries – notably those in Silicon Valley – often stress such "externalities."

Note, too, that an influx of skilled workers would narrow the income gap between skilled and unskilled workers in the United States. On both

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efficiency and distribution grounds, therefore, it would seem that social welfare increases most when the immigrants are skilled.

The Point System. In the past few decades, Australia, Canada and New Zealand have all adopted point systems that reward certain socioeconomic traits. In Canada, for example, a person who is 48 years old (my age) gets just 2 points out of a possible 10 and another 16 if he or she happens to have a doctoral degree. Further, he or she gets 1 point for being an economist (out of a possible 10 for occupational background), 8 points for having more than four years of work experience, 9 points for being fluent in English, 0 points for having no relatives in Canada (out of a possible five), and so on.

After all is said and done, this person – who is very much like me – would get 67 points. Unfortunately, the Canadian point system demands that a visa applicant get 70 points out of a possible 112, so I would be denied entry to Canada.

Any point system will lead to some inscrutable conclusions. A few hapless government bureaucrats must decide which characteristics will enter the admissions formula, which occupations are most beneficial, which age groups are to be favored, how many points to grant each desired characteristic and so on. In Canada, the list of occupations and the points granted to each occupation stretches through 10 pages. If I had been a social worker instead of a social scientist, I would have passed the test.

The point system also emphasizes easily observable characteristics. These characteristics may help determine productivity. But they are not the only things – in fact, they are not even the main things – that matter. Differences in education, age and occupation explain only about a third of the variation in earnings among United States workers.

Despite these limitations, a point system has two things going for it: It is simple, and it works. The Canadian point system really does match immigrant skills with labor market needs and reduces the fiscal burden that immigration places on Canada's generous system of public assistance.

The Canadian experience suggests that the United States, too, could increase the skill level of its immigrant population by adopting a point system that relies on a few socioeconomic characteristics. The formula could also award points to workers in "urgently needed" occupations, to applicants who have an American job offer before entry and to persons who already have relatives living in the United States. Family connections with United States residents would still matter, but they would no longer be the only thing that matters.

In 1997 the United States took some tentative steps toward using information about the economic potential of migrants in its immigration policy. Sponsors of new immigrants – – typically family members who already live in the United States and want to bring in their relatives – must have a household income exceeding 125 percent of the poverty line. So a married couple with two children sponsoring the entry of two relatives must have an annual household income exceeding $26,000.

This filter, however, links the entry visa to the sponsor's characteristics rather than the applicant's. It would be preferable to stress the economic potential of the immigrants themselves. After all, these are the people who will have the largest impact on the economic well-being of natives.

Finally, it is worth stressing that a point system addresses only the demand side of the immigration equation. In the end, the United States can admit only those immigrants who wish to enter. And for many reasons, includ-

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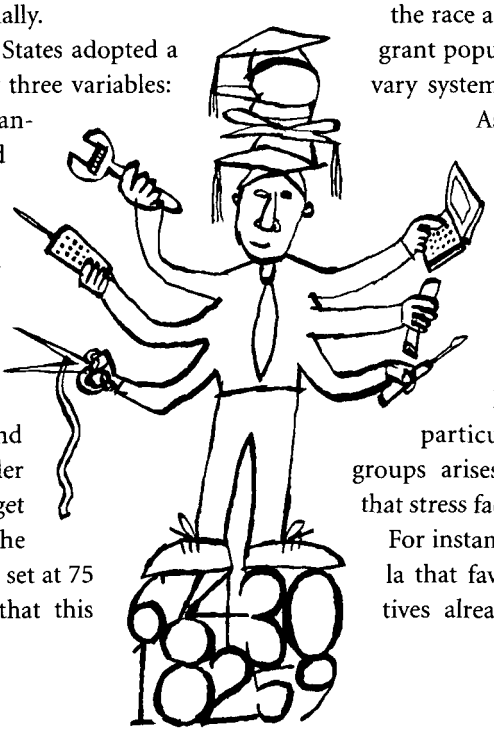
ing the narrowing of the income gap between the United States and other industrialized countries, the United States largely attracts less-skilled workers from developing countries. If a skills-based point system were adopted, most visas would be granted to skilled workers – but the numbers granted would be relatively small.

I do not view this prospect as a flaw of the point system. It simply means that the types of workers the United States wants to "buy" are not available at the price the country is willing to offer. America could offer financial incentives to the immigrants it truly wants. Australia did for many years, reimbursing desired immigrants for the expense of getting there.

National Origin and the Point System. It is important to be candid about the way such a point system would actually work. In particular, one should not overlook the fact that a system emphasizing skills would have a huge impact on the national origin mix of the immigrants. Most likely, immigration from Mexico and some other developing countries would decline substantially.

Suppose the United States adopted a point system with only three variables: education, English language proficiency and age. Suppose persons who had at least a high school diploma would get 50 points; persons who were proficient in the English language would get 25 points; and persons who were under 40 years of age would get 25 points. Finally, the passing grade would be set at 75 points. Suppose, too, that this point system had been in place in 1990.



About 40 percent of the immigrants who actually entered the country in the late 1980's would have failed this test. Even more striking, almost three-quarters of the Mexicans who entered the country would have failed to get visas, compared with 30 percent of Italians and 12 percent of Canadians. And even though Mexican immigrants made up for 18 percent of the actual immigrant flow in the late 1980's, they would have accounted for less than 8 percent if this point system had been in effect.

This exercise does not present the complete picture of the consequences. A point system would also change the applicant pool, encouraging more skilled persons to apply. Nevertheless, the system would have a disproportionate impact on applicants from developing countries, if only because a relatively small percentage of the population of those countries has completed high school.

Opponents of a skills-based point system would no doubt denounce it as inherently racist. But such an immigration policy affects the race and ethnicity of the immigrant population only because skills vary systematically across countries. As long as the United States favored the admission of skilled workers, persons who originate in countries with abundant human capital – the rich, white countries – will be overrepresented. Moreover, bias toward particular national origin groups arises even in point systems that stress factors other than the skills. For instance, an admissions formula that favors applicants with relatives already in the United States

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EFFECT OF A HYPOTHETICAL POINT SYSTEM ON THE NATIONAL ORIGIN MIX OF THE 1985-1990 IMMIGRANT FLOW

COUNTRY OF ORIGIN	PERCENT OF GROUP THAT FAILS THE TEST	PERCENT OF IMMIGRANTS ORIGINATING IN COUNTRY
ALL COUNTRIES	**40.7**	—
EUROPE		
France	7.4	0.6
Germany	14.4	0.6
Greece	30.6	0.3
Ireland	9.6	0.7
Italy	29.5	0.5
Portugal	70.1	0.5
United Kingdom	6.2	0.6
AMERICAS		
Canada	12.2	1.8
Cuba	66.6	1.1
Dominican Republic	58.4	2.0
El Salvador	77.0	2.9
Haiti	54.1	1.2
Mexico	74.6	18.4
Nicaragua	56.6	1.7
ASIA		
China	42.9	4.7
India	18.8	3.9
Korea	29.3	3.9
Vietnam	62.5	2.7
Philippines	15.0	5.8

gives an advantage to ethnic groups that have recently migrated. In 1990, only 15,000 adult immigrants had been born in Bangladesh (with nearly 130 million inhabitants), and fewer than 200 adult immigrants had been born in the Democratic Republic of the Congo (with about 50 million inhabitants).

The Point System and Immigrant-Dependent Industries. It is often claimed that some domestic industries would cease to exist – or at least would have to change radically – if immigration did not provide a continuing supply of cheap workers. For example, nearly two-thirds of farm workers in the United States and 90 percent of those in California are foreign-born.

The debate over the expansion of the H-1B ("high-tech") temporary visa program in 1998 illustrates the economic issues at stake. Employers of software programmers and engineers insisted that their industries were plagued by chronic shortages that could be alleviated only by an increased supply of foreign-born "high-tech braceros." Workers already employed in those industries responded that the labor shortage was a figment of their employers' imaginations – one conjured to increase the supply of workers so that the companies could pay lower wages. Before 1998, the United States annually granted 65,000 temporary visas to high-tech workers. The debate ended with Congress voting to increase the number to about 115,000 annually for three years.

A skills-based point system along with a substantial cut in illegal immigration would obviously have a disproportionate effect on some industries, notably agriculture. In principle, one could soften the impact by granting additional points to "urgently needed" workers with specific skills. Before such exemptions are routinely granted, however, one should consider whether the exemptions improve social welfare.

In 1776 Adam Smith warned that "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public or in some contrivance to raise prices." And the warning is still relevant.

Trade groups like to claim that their industries face serious labor shortages and that the shortages can be eliminated only by bringing in more workers. It is certainly the case that agriculture could not survive as it is currently structured in the wake of the reforms I favor. But it is worth asking a different question: does it make sense for the United States, a country with a relative abundance of skilled labor, to be in the business of growing hand-harvested fruits and vegetables?

The economic law of comparative advan-

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tage shows that some goods are best produced abroad and imported. Even putting aside this reality, one could still argue that what is good for the employers need not be good for the country. For instance, agricultural companies that hire seasonal workers in California ignore the fact that the immigrants impose a burden on the native population during the off-season. Although some of the immigrants return home after the harvest, many remain to increase the demand for social services.

Immigrant-dependent industries would surely adapt to a different economic environment. Some companies would turn to capital-intensive technologies that allowed them to remain competitive. Consumers would also adapt: If California oranges became too expensive, they could buy their juice from Brazil – or switch to apple cider.

How Many Immigrants? Though the evidence on the economic impact of immigration provides a clear road map for thinking about who should be admitted, it provides little guidance for deciding how many. The policies regulating immigration let in almost one million immigrants annually during the 1980's and 1990's, not counting political refugees. Is one million too many or too few?

It is tempting to interpret the current emotional debate over immigration as a sign that the United States is admitting too many. The symptoms of dissatisfaction include majority support for California's Proposition 187, which denied government benefits to illegal aliens, and the welfare reform legislation of 1996, which made it more difficult for legal immigrants to qualify for public assistance. However, one can also interpret these signs as a response to the perception that the United States is admitting the wrong type rather than the wrong number of immigrants.

An alternative way of posing the question is to imagine a contrary situation. What would be the nature of public discourse if the immigrants were one million highly skilled workers? I think the United States would still be in the midst of a debate, and perhaps an even more heated one. After all, skilled immigration would have substantial consequences for well-heeled constituencies.

Suppose the United States were to admit only college graduates, and this policy were to remain in effect for two decades. By the year 2020 roughly 15 million skilled workers would have been added to the work force (assuming that 75 percent were working). Now, there were roughly 30 million college graduates working in the country in 1998. So the policy would increase the supply of college graduates by 50 percent. And the available evidence suggests that a 50 percent increase in the supply of skilled labor would reduce the average wage of college graduates by 15 percent.

The negative impact doesn't end there. The reduction in relative wages would probably affect college enrollment. If a change in immigration policy were to cut the return to college by 15 percent, the available evidence suggests a reduction in enrollment by between 15 to 30 percent.

Moreover, disadvantaged native students would probably be most sensitive to the decline in the returns to college, and their enrollment rates would probably drop the most. These are the students, after all, who can least afford college in the first place. So even though some narrowing of the wage gap may be desirable, a large narrowing may not. And, in my view, a 15 percent cut in the salary of college-educated workers would be sufficiently large to be worrisome.

Choosing the magic number of skilled workers is bound to be a painful process of trial and error. A good place to start might be

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to let in 500,000 legal immigrants per year – roughly the number recommended by the Commission for Immigration Reform and a one-third cut from the number of legal immigrants admitted during the 1980's and 1990's. This also happens to be the average number of immigrants who entered the United States during the 1970's, a period of relatively high immigration when the political debate focused on the perceived problem of illegal entry.

It makes little sense to create a policy that cannot respond to changes in economic conditions. The number of immigrants that maximizes social welfare is probably smaller when the economy is weak and larger when it is strong. The point system, therefore, should take account of macroeconomic conditions. For example, when the economy is near full employment, 500,000 entry visas could be awarded. The number of visas might decline to 450,000 if unemployment rose to 7 percent, and so on.

Illegal Aliens. Five million illegal aliens lived in the United States in 1996. Their numbers grow by about 300,000 per year. And these figures are on top of the three million illegal aliens who were granted amnesty in the late 1980's.

The common perception of an illegal alien is of someone who crossed the border without permission. The Immigration and Naturalization Service refers to these persons as E.W.I.s, for "entry without inspection." The stereotypical E.W.I. is a Mexican who walked across. Many illegal aliens, however, had legal student or tourist visas when they first entered but remained after their visas expired. Illegal aliens, therefore, come from many places. Almost half of the illegal-alien population is from countries without a common border with the United States.

The United States attracts illegals for many reasons. Average income in the United States is at least three times larger than in Mexico. Even after netting out the cost of getting to the United States border, the income differential between the two countries remains a potent incentive to move.

Second, few penalties are imposed on the illegal aliens who are caught. They are simply put on the first plane or bus going back home. And once home, they are free to try to reenter the United States whenever the opportunity arises.

Third, even though it is illegal for employers to "knowingly hire" undocumented aliens, the chances of getting caught are negligible and the penalties are trivial. Newly hired workers must offer proof that they are United States citizens or permanent legal residents or that they have work visas. Employers then complete forms for each new employee certifying that the relevant documents were reviewed.

The statutes, however, have a huge loophole: the employer is not required to keep copies of these documents. Hence, there is practically no chance of detecting employers who decide to hire illegal aliens after "reviewing" patently phony work credentials.

Finally, the United States does a poor job of controlling its borders. The reasons are understandable. Although the number of agents in the Border Patrol rose from about 3,000 in 1990 to nearly 10,000 in 1998, the Mexican-United States border is 1,950 miles long.

A number of highly publicized Border Patrol operations in the mid-1990's attempted to curtail illegal immigration with a round-the-clock police presence in stretches that illegal aliens typically used to cross. These operations seem to have been effective in the targeted areas, but some of the illegal aliens eventually entered by crossing in less

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heavily patrolled places. Indeed, a study commissioned by the governments of Mexico and the U.S. concluded that "the United States border enforcement strategies begun in 1994 are affecting migration patterns, but not preventing unauthorized entry."

Moreover, tighter controls on the border do not address the problem of how to curtail the number of aliens overstaying their visas. They account for about half of the illegal aliens in the United States.

ILLEGAL IMMIGRATION IN THE UNITED STATES
OCTOBER, 1996

	NUMBER OF ILLEGAL ALIENS
TOTAL	5,000,000
"TOP FIVE" COUNTRIES OF ORIGIN	
Mexico	2,700,000
El Salvador	335,000
Guatemala	165,000
Canada	120,000
Haiti	105,000
"TOP FIVE" STATES OF RESIDENCE	
California	2,000,000
Texas	700,000
New York	540,000
Florida	350,000
Illinois	290,000

Any serious reform of immigration policy and any attempt to adopt a skills-based point system are doomed unless the problem of illegal immigration is also resolved. Both the morality and the political legitimacy of immigration restrictions come into question if one can get to the front of the queue by breaking the law.

Note, too, that illegal immigration may be the cause of substantial social and ethnic conflict, particularly in California where voters enacted Proposition 187 in 1994. This denied many locally provided benefits, including education, to illegal aliens.

Proposition 187, in fact, raises fundamental questions about how far the United States can or should go in controlling the illegal-alien flow. Much has been made, for instance, of the rights and wrongs in denying a public education to the children of illegal aliens. Supporters of Proposition 187 argued that illegal immigration has lowered the quality of education in California schools and that a ban on educating undocumented children would reduce the incentive for illegals to come. After all, if illegal aliens respond to changes in wages for tomato pickers, they would surely respond to the cut in education benefits.

Opponents of Prop 187 argued that it is morally wrong to kick children out of school and that, in any case, it makes economic sense to educate illegal aliens. Preventing illegals from getting a high school diploma today will only buy the United States more poverty, welfare and crime tomorrow.

Putting the moral issues aside, barring illegal aliens from public schools simply may not be an effective way of stopping the flow. Many of the children who live in households headed by illegal aliens were born in the United States and are American citizens, courtesy of the 14th Amendment. Thus, the denial of public education affects a relatively small part of the illegal population, and, in any case, would probably not deter the migration of single persons and childless couples.

The United States could probably deter many more illegal aliens by imposing substantial penalties on the employers who hire them. These employers – large farms and sweatshops, as well as native households that hire illegal aliens as maids or nannies – get the bulk of the gains from illegal immigration but bear few of the costs. The demand for illegal aliens would probably drop drastically if the government began to bill the owners of the fields where the aliens toil and the families who hire illegal servants for the extra expenses incurred by public schools and Medicaid.

There should also be penalties exacted on the illegal aliens themselves. Some want illegal

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aliens sent to detention centers, so that they can pay for their crime through incarceration. But it is very expensive to keep people in jail. If every apprehended illegal alien (there were 1.6 million of them in 1996) were forced to spend two weeks in a federal prison, the annual bill would be around $1.3 billion – assuming no prisons had to be built.

One alternative might be to punish the illegal aliens by hitting them where it hurts the most, in the pocketbook. Federal law, for example, routinely allows the confiscation of property used by drug dealers in their illegal business activities. By analogy, aliens could be fined for their illegal activities through the confiscation of their assets before deportation. The assets reverting to the United States Treasury might include the right to collect Social Security benefits.

These penalties would probably drive the economic activities of illegal aliens further underground. But the financial penalties – if accompanied by a strong effort at apprehending the aliens – could trim the economic benefits associated with migrating to the United States.

Ultimately, any serious attempt to resolve the illegal alien problem faces a crucial obstacle. There must be a simple way of determining who is an illegal alien and who is not. After all, it is unreasonable to increase the penalties on employers who hire illegal aliens if it is difficult for employers to determine their legal status. But Washington has yet to grapple with this troublesome reality because it raises the specter of a national identification system.

Most Americans have a libertarian streak that leads them to reject the notion of carrying a proof of residence for potential employers. Yet most Americans carry credit cards that are scanned, and transactions are recorded by credit agencies. However one feels about such breaches of privacy, the basic dilemma is clear: the illegal alien problem will remain as long as the United States skirts the question of how to identify who is a legal resident and who is not.

Finally, one might encourage the parties involved in the immigration debate to take illegal immigration more seriously by linking the numbers admitted legally to the estimated size of the illegal flow. Suppose the United States were to adopt a system that granted 500,000 legal visas each year. These slots would become more valuable if the government reduced the number of legal visas available to offset illegal immigration on a one-for-one basis. If, for example, the I.N.S. reported that 200,000 illegal aliens had entered the country, only 300,000 legal visas would be granted the following year.

This toll on legal immigration would introduce a number of important incentives for enforcement. First, it would make the country aware of the magnitude of illegal immigration. Second, it would give companies that employ immigrants something to lose in opposing reasonable constraints on illegal immigration. Finally, it would give the legal immigrant community a strong incentive to stop the illegal-alien flow, since each illegal alien who entered the country would make it that much harder for the relatives of United States residents to enter.

Refugees. Persons seeking refuge from political oppression have a very strong moral claim to entry. And although there have been some glaring exceptions, the United States has taken this responsibility seriously in recent decades. The President (in consultation with Congress) sets an annual limit on the number of refugees granted admission and determines how these visas will be distributed. In 1996, the ceiling was 90,000, with 25,000 visas granted to East Asia and 45,000 to Eastern

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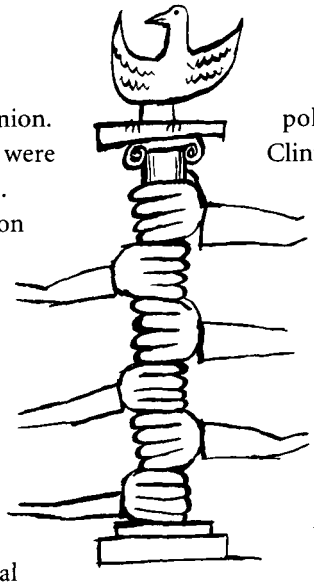
Europe and the former Soviet Union. Nearly 1.8 million refugees were admitted between 1980 and 1996.



Participants in the immigration debate have seldom disagreed over the country's obligation to refugees. Nevertheless, there is an unresolved operational question in refugee policy, a question that is likely to play an ever-larger role in the debate: Who is a refugee?

Were the Mariel boat people from Cuba fleeing political oppression or poor economic conditions in 1980? Why were they considered refugees and welcomed with open arms, while Haitians fleeing equally oppressive economic conditions were denied refugee status?

Despite the humanitarian veneer on most discussions of refugee policy, it is safe to conclude that the determination of refugee status mostly reflects the objectives of American foreign policy and the influence of domestic political interests. Before 1980, the United States defined a refugee as a person fleeing a communist country, a communist-dominated area or the Middle East. The Refugee Act of 1980 redefined a refugee as someone who is residing outside his or her country of nationality and who is unable or unwilling to return because of a "well-founded fear of persecution on account of race, religion, nationality, membership in a particular social group or political opinion."

A good example of how the post-1980 definition adjusts to the changing political winds occurred in 1995. Before that time, persons fleeing the communist regime in Cuba were automatically granted asylum once they reached the United States. To reduce the chances of a new boatlift that would have devastating effects on Florida's political landscape, President Clinton reversed this decades-long policy by proclaiming that Cuban citizens would no longer receive preferential treatment in their applications for asylum.

Admission as a refugee has certain advantages. Persons who do not have relatives in the United States and do not qualify for employment-based visas find that refugee status offers the only route to legal entry. Second, refugees are entitled to an array of social services unavailable to other immigrants – and sometimes even to natives. In 1995, the Office of Refugee Resettlement spent almost $400 million providing cash, medical assistance, English language training and employment-related services to refugees.

The United States should continue its tradition of offering sanctuary to those in need. Nevertheless, there are two issues worth keeping in mind. The evidence indicates that refugees are very likely to be enrolled in welfare programs. After 10 years in the United States, 16 percent of Vietnamese refugees, 24 percent of Cambodian refugees and 34 percent of Laotian refugees were still receiving public assistance. Moreover, the refugees' exceptional use of welfare cannot be attributed solely to differences in socioeconomic characteristics, such as education and household composition. I think it would make sense to eliminate this particular benefit and simply provide the same types of assistance given to other immigrants in similar economic circumstances.

The more important issue is the definition of a refugee. There was little discussion of what constituted a refugee during the cold

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war: the United States automatically offered sanctuary to all fleeing communist regimes. However, this consensus collapsed with the Soviet Union, and the operational meaning of refugee is now up for grabs. In the 1990's, the debate took an ominous turn by introducing differences in cultural norms.

Consider, for example, the debate over whether women who live in cultures that permit genital mutilation qualify for refugee status. An immigration tribunal in the United States eventually granted asylum to one such woman who had fled her homeland to escape the ritual. But the ruling raises a fundamental question: are people who live in societies that allow conduct abhorrent to most Americans entitled to asylum? And if so, how offensive must the conduct be to qualify? For instance, do families residing in countries where the children are sent to work at the age of 10 make the cut?

Broad definitions of what constitutes a refugee are ripe for abuse and could be used to award refugee status to millions of persons who are now subjected to all manner of offensive behavior. The danger is that the looser the definition of refugee status, the harder it becomes to maintain the political legitimacy of programs that aid refugees. And the harder it becomes to give refuge to those who need it most.

CONCLUSION

The First Great Migration that began around 1880 and ended abruptly in 1924 was an exceptional event. Never before had such a large population movement occurred over such long distances and in so short a period. Remarkably, it took less than a century for history to repeat itself. The Second Great Migration began at the end of the 1960's and has yet to subside. By the time the 21st century begins, almost 30 million persons will have arrived on this wave.

The United States is only beginning to feel the consequences. Regardless of how immigration policy changes in the future, the Second Great Migration has already set in motion a series of events that will alter the social and economic structure of the United States, not only in our generation but for our children and grandchildren as well.

For better or worse, economic issues often frame the immigration debate. And the weapons of choice in this debate are economic statistics and analysis. Will this evidence influence the direction of the immigration debate? Should it?

Yes, and yes. The evidence suggests that Americans would be better off if immigrants were more skilled. And it can be plausibly argued that a smaller number of immigrants would be beneficial for the country. But major changes in immigration policy occur only rarely. Therefore, the road ahead is long and fraught with dangers.

The adverse effects of the Second Great Migration will not go away simply because some do not wish to acknowledge their existence. But the longer the delay in reform, the greater the chances that when immigration policy finally is changed, it will undergo a destructive shift. That shift may give a victory to those who advocate closing the border, denying Americans the benefits of a well-designed immigration policy.

That would be extremely unfortunate. Immigration has blessed the United States throughout much of its history. If one goes back far enough, every country is a nation of immigrants. But the United States is unique in this regard. No other nation has offered such a beacon of hope to tens of millions of persons from around the world. And nowhere has this beacon shone so brightly for so long.

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"If you're an economist, why aren't you rich?"

That hoariest of put-downs has no effective comeback. While there have been some famous exceptions – 19th century economist David Ricardo was a financial mogul – the vast majority of economists (particularly the academic breed) don't have much wisdom to impart on the subject.

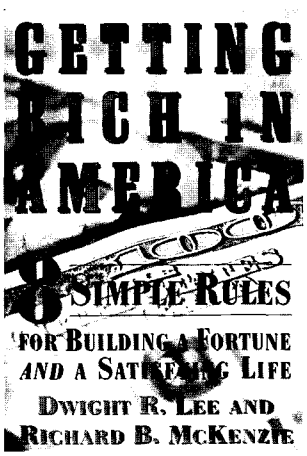
Or at least until now.

Getting Rich in America: Eight Simple Rules for Building a Fortune and a Satisfying Life

By Dwight R. Lee and Richard B. McKenzie

Harper Business Books, 221 pages, $25.00

Reviewed by David R. Henderson



Enter two academic economists, Dwight R. Lee of the University of Georgia and Richard B. McKenzie of the University of California at Irvine, who take the matter of hunting and gathering very seriously, indeed. And their book lives up to its title. If you follow their rules – all of which are familiar homilies – then, with a little luck, you really will build a nest egg of $1 million or more in today's dollars by age 65.

The recent best seller, *The Millionaire Next Door*, by Thomas Stanley and William Danko, punctured a lot of myths about the roughly four million millionaires in America, showing the typical American with a seven-figure net worth to be a high saver in an unglamorous job who has nothing close to an extravagant life style. Think of *Getting Rich in America* as the how-to handbook for becoming the millionaire next door.

Perhaps the most important of the eight rules are the first two. One is to think of America as a land of choices. That may not sound profound, but it is. The next time you find yourself bemoaning your lot, instead of asking "why me?" ask yourself, "what can I do to change things?" As Ron Jones, the co-owner of Handy Andy Janitorial Services in Plano, Texas, puts it in the book: "If you want your prayers answered, get off your knees and hustle."

The other key rule: take the power of compound interest seriously. Lee and McKenzie provide many examples, showing that even

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people with relatively low incomes who save modest amounts can become wealthy late in their lives. For example, someone who at age 22 starts a job at $30,000 a year, earns a real wage increase of only 1 percent a year thereafter and saves just 10 percent of his or her income at a real return of 8 percent, will end up with $1.2 million at age 65.

Eight percent may sound high for a real rate of return. The authors point out, though, that it is the average that stocks in the Standard & Poor's 500 index earned between 1926 and 1997. There are two problems with their use of the S&P average, however. The stock market didn't provide a constant real return of 8 percent; returns were highly variable. This means that if you were the hypothetical person above, you could accumulate substantially less – or more – than $1.2 million. Still, you would probably have to do very badly to end up with less than, say, $600,000.

The more serious, problem here is that the stock market's return in the past proves nothing about the future. What if the 1990's run-up in the stock market came about because investors finally realized how good an investment stocks are? If so, the market has already capitalized a good chunk of those otherwise-higher returns – which would mean that future returns may well average less than 8 percent.

So if you're very pessimistic about the stock market, assume a real return of 5 percent. Interestingly, the authors show that, at that rate, our hypothetical saver will have "only" $525,000 at age 65. But Lee and McKenzie note that the median wealth of families headed by individuals age 65 or older is only about $106,000. So even if you don't literally become a millionaire by following their rules, you can certainly build your wealth to a multiple of the median.

There's still a catch, of course: how do you save 10 percent of your income? With rule three: resist temptation.

Distinguish, say the authors, between your needs and your wants. The money spent on little luxuries, they point out, adds up – or, more precisely, compounds up – if it is saved. Assume that you save $1.35 a day by buying a regular coffee rather than a cappuccino; add another $7 a week by brown-bagging lunch one day in five. That amounts to $857.75 a year. If you manage that modest feat from age 25 and invest the saving at 8 percent, you will end up with an extra $282,700 by age 67.

Lee and McKenzie also show that if you buy a two-year-old car rather than a new one, you pay only about two-thirds as much. And some 37 percent of millionaires do buy used cars – which is one reason they're millionaires.

Can even the poor save? The average poor person, the authors note, spends 2 percent of household income on lottery tickets. Switch to index funds and that person is already one-fifth of the way to a 10 percent saving rate.

For roughly the past 16 years, I have followed all eight of Lee's and McKenzie's rules, in moderation. My experience is that it gets easier and easier. As one talk-show caller said to Lee, "I don't think of my savings as a sacrifice, I think of it as purchasing financial freedom."

Anyway, consider the alternatives. If you follow none of the rules and never get a cushy inheritance, you will retire only on Social Security. Now that's tough.

Most of their other 8 rules also have a strong compound-interest component. Take number four – get a good education. Guess how much extra wealth you would have by age 67 if you finished a college degree in three years instead of the now-common five, and invested (at 8 percent) your whole after-tax income for those additional two years? With

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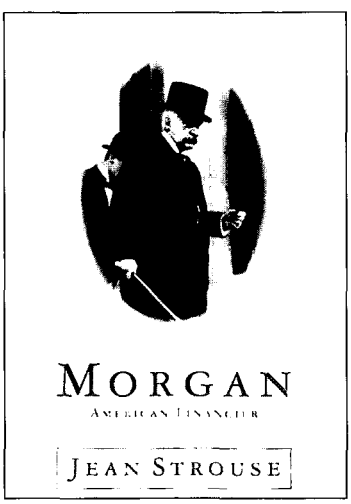
a before-tax income of $39,000, Lee and McKenzie show, the increase in wealth from graduating early is a whopping $1 million. (If you consumed half of your-after tax income for those first two years, your net gain from finishing early is still $500,000).

But there is more to their analysis than compound interest. Rule five for a wealthy and satisfying life is to get married and stay married. Lee and McKenzie point out that married people live longer and are healthier. Divorce, they also note, is expensive for both sides. As economist Barry Asmus once put it, "48 percent of men, when they leave their house, kiss their wife goodbye; 92 percent of men, when they leave their wife, kiss their house goodbye."

Lee and McKenzie do justice to the other part of the subtitle: building a satisfying life. Under rule six, "Take care of yourself," for example, they focus on maintaining your health in little ways – moderate exercise and diet, for example. Here, though, I found one major surprise. The thrust of the book is that small choices have a big impact. Yet in one area, they don't. Maintaining an appropriate weight, as compared to being 25 percent overweight, adds a mere 10 months to your life expectancy.

Their other rule for a satisfying life is number eight: strive for balance. Here they advocate "giving back." But all their examples are of people who had little given to them and who gave to those who gave nothing to them. So where's the "back?" I like the principle of giving. But it's not giving back, nor does it need to be. Giving is its own reward. ■



Morgan: American Financier

By Jean Strouse.

Random House. 799 pp. Cloth $34.95.

Reviewed by Martin Mayer

ONE EMERGES FROM Jean Strouse's long and admirable biography of J.P. Morgan almost as puzzled about the main character as when one began. In part, this is because Morgan was unique in the history of his country and the history of finance. In part, because he was a private man who told little of himself – and that little was poorly told – as he had no disposition to explain and was inarticulate even on those rare occasions when he did wish to speak. Strouse manages nonetheless to weave a tale of the financier's life neatly punctuated with anecdotes, many of which had never before seen the light of the printed page.

A sickly child, subject to fits of depression as an adult, Morgan was both driven by his business and eager to be away from it. He was also broadly curious, with artistic, archaeological, musical and literary interests far beyond those of the usual intellectual, let alone the usual businessman. He was unimaginably rich, and spent money as fast as it came in. When asked what it cost to run a yacht like his (the *Corsair*), Strouse reports (amending the best-

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known Morgan story) that Morgan replied, "If it makes the slightest difference to you what it costs, don't try it."

The book is full of incidents in which Morgan was asked for much more than he had expected to pay for a painting, a statue, an antique chair, a Persian miniature, a manuscript – and simply paid. One suspects that the profits of his bank were recorded after a lot of his extravagances that today's accounting practice would not permit as a business expense. But in those days nobody cared. The money was always there, then gone, then replenished for almost 40 years.

J.P. Morgan was America's first second-generation international banker. His father Junius became partner and heir to the bachelor George Peabody in London, when Pierpont was 17. On graduation that year from Boston English (his ninth school), he was sent to Switzerland to learn French (the next summer he translated for the family when they were all in Paris). Then it was on to Gottingen – his one contact with a university – for a year of math and chemistry, Gottingen's specialties, in German.

Strouse quotes Morgan's daughter Louisa as saying that his favorite reading matter was lightweight Victorian romances. But he did have a library full of classics, which he may well have read. And Strouse implies that he knew a lot more about literature than Victorian romances could have provided, reporting a dinner where he was not his usual diffident self, roaring arcane French poetry at his companions.

While putting together the great trusts that owned railroad lines and steel companies, steamship lines and telegraph companies, while rescuing the government in a gold crisis and the financial system in a banking crisis, he made time to tour (and raid) the world's great museums and libraries, to attend the opera, to visit archaeological digs, to eat like a horse, to watch sailing races from the deck of his enormous yacht and to enjoy the attention of beautiful women who found him irresistible despite a monstrous purple nose. Strouse has mined a number of previously virgin archives for the details, and it's greatly to her credit.

Strouse also remembers every hundred pages or so that her politics are very different from Morgan's, and she delivers sermons about how dreadfully the working class lived while Morgan spent fortunes on his pleasures. Case in point: "Had he been more concerned about the social costs of industrialization, he might seem more sympathetic now," she says. But when she comes to specific events (barring an early episode when Morgan was a partner in a venture that defrauded Abraham Lincoln's wartime army by selling back rifles acquired from Government stocks), she finds the interpretations of Morgan's friends more plausible than those of his enemies.

Morgan saw his life's work as the avoidance of what Schumpeter later called "creative destruction." A true conservative, he regretted (and, when possible, rebuffed) the competition of newcomers whose new railroad, steel mill or sugar refinery would endanger the returns on their predecessors. As he acknowledged, Morgan was always better at consolidation than at innovation.

Strouse explains: "railroads were 'natural monopolies' in their own territories – one railroad could do the job more cheaply than two. Yet that road needed large volumes of traffic to stay in business because of its high fixed costs. By running big trains loaded full, line A could keep its operating costs low, and earn enough money to service its debt and turn a profit. If a parallel line B slashed prices to siphon off A's traffic, A would have to

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match the price cuts in order to maintain some volume and income. ... The logical outcome of this struggle seemed to be bankruptcy for all – which was why competition among capital-intensive railroads seemed 'ruinous' to their owners and managers. And the failure of enormously expensive roads, financed largely by foreign capital, affected the entire U.S. economy."

There is something to this sort of argument. I remember once giving a talk to a group of shopping-center developers, one of whom asked whether a man who had done it right – got the right anchor tenants, the right place by the interstate highway, the best boutiques, etc. – would ever be safe from some stupid bank that financed the construction of another shopping center at the adjacent exit. And I had to say no.

But I would argue the assumption that aspiring competitors are idiots does not usually hold up: It's the fact that line B can undercut line A's tariffs and still make money that stimulates the new investment. New technology may make it cheaper to provide the service, or the established line may have developed a sclerotic bribe-taking bureaucracy, or may be collecting monopoly rents big time. The banker who protects the enterprise may do a service for its stockholders and creditors, but not for its customers or for the country.

Morgan, Strouse writes, "believed. . . in the need for administered markets" (it is a measure of her economic and political sophistication that she describes this belief as "liberal"). And administered markets, as the Soviet economic bloc so vividly demonstrated, frustrate the introduction of new processes, products, ideas and producers.

This is why Morgan was reviled beyond the other "malefactors of great wealth," to use Teddy Roosevelt's great phrase for the likes of Hill and Huntington, who built railroads; Carnegie, who built ever-better steel mills; McCormick, who built agricultural machinery, and Pullman, who built railway cars. Morgan was occasionally involved with new ventures (over the objections of his father, who kept a hand in the business from London long after his son had taken over in New York). He backed Thomas Edison's electric light from early on, and, perhaps more interestingly, took a flier with Nikolai Tesla, who pioneered the alternating-current electric motor. As a normal matter, however, he was engaged not in creating the new but in reinforcing and reorganizing the established, raising money for governments and for large enterprises that had come on hard times or thought they could make more money by growing even larger.

Morgan, the consolidator of industrial America, was oddly a stranger in his own land. He seems to have made only two substantial voyages west of the Hudson, both in palatial railway cars that stopped as infrequently as possible. He had homes in Manhattan, up the Hudson (where there was a dock for the yacht), and in millionaires' clubs in Newport, the Adirondacks and Jekyll Island off Georgia. But nine-tenths of his days away from the office were spent in England, France, Germany, Italy and Egypt. In the centennial summer of 1876, for example, he took his family to England where they celebrated July 4th in a London hotel.

And for all his influence on the American economy, Morgan was oddly detached from the bricks-and-mortar aspects of enterprise. He supervised a paper business rather than a real business. He could make decisions from far away because there was nothing to actually see nobody to actually meet. The decisions he made were further removed from the people who worked in the businesses that his

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bank controlled, or who consumed their products or services. Presumably this reinforced the collective myth of a modern industrial economy controlled by unseen, sinister hands.

Indeed, the view of the banker as parasite has long antecedents. To the extent that Morgan served the interests of the already rich, with a first goal of squelching nascent competition that might benefit workers and consumers, he deserved the opprobrium. And as the railroads he reorganized went bust and sought his help again – with a fee for J.P. Morgan & Co. and a profit on the resale of the paper – public suspicion grew.

To Morgan's credit, however, Strouse observes that he "had meritocratic instincts." Perhaps the most striking illustration was the partnership he gave Egisto P. Fabbri, an Italian-born American who joined Morgan's firm from the shipping industry with no less than a 15 percent share. When Junius Morgan in London expressed astonishment, his son replied, in effect, that good men are hard to find.

Such snippets demonstrate Strouse's superb academic detective work. Far more impressive, Strouse answers a question that bedeviled New York society for two generations: the identity of Belle da Costa Greene, the lissome, fierce, olive-skinned librarian who became Morgan's agent, confidant and probably his best friend when she was 22 (she said) and Morgan was 67. (Strouse doubts they were lovers) Morgan's will pretty much required his son to retain Belle Greene as librarian of the Morgan Library. And she cut a swathe in New York society and in the art world – she was, among other things, the great financier Bernard Berenson's lover – for more than forty years.

It seems that Greene had concocted a Portuguese background for herself. And prior to the publication of Strouse's book nobody knew she was really the daughter of Richard T. Greener, the first Afro-American graduate of Harvard College. He was the U.S. consul in Vladivostock when his daughter became Morgan's librarian. This fascinating material, published separately in *The New Yorker*, raises the saddest of questions: What kind of society was it that required the daughter of so distinguished a man to disown her heritage to get ahead in the world?

Morgan: American Financier is also, unfortunately, a book of lists: the 10 distinguished young men who avoided conscription by hiring a substitute at $300 each and the 9 distinguished young men who didn't; the 11 founders of the Metropolitan Club; the 8 guests who came with Morgan on the train to Hartford and the 7 honorary pallbearers at his father's funeral; the 70 guests at Louisa Morgan's wedding; the 12 early visitors to the private showings of his London art collection in 1901; the 10 "admirers" of Lady Victoria Sackville, and the 14 contributors to an issue of Edward Steiglitz's magazine devoted to Morgan's New York residence.

There is also too much about too many of Morgan's artistic acquisitions. And the mix of chronology and analysis, admittedly hard to pull off, does not always work: The reader must sometimes skip back through pages to find out which year he or she is in.

And there is a major omission: Except for the famous story of Morgan banishing Richard Strauss's Salome from the Metropolitan Opera (which Strouse gets subtly wrong) there is nothing about Morgan and music.

Morgan, after all, owned the box at the center of the great horseshoe for every performance the Met gave in his lifetime. And sometimes he even attended: The Met

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archives give some remarkable menus of what the caterers served in his anteroom. Holograph scores of the great composers – Bach neat, Mozart slapdash, Schubert in a frenzy of self-correction – are among the glories of the Morgan Library.

The real Salome story is, in fact, more interesting than the Strouse version, and illustrates something important about Morgan that Strouse does not articulate. She reports that Morgan's daughter Louisa had been disgusted by the premiere and that "four days later the Opera's board, on which Morgan sat, notified its director that the production was 'objectionable and detrimental to the best interests of the Metropolitan.'"

Here's what really happened. The board on which Morgan sat had nothing to do with opera production; rather, the boxholders were on the board of the Real Estate Company, which had built and owned the opera house and got eight free tickets to every performance by the production company to which it rented the building. The production company was chaired by Otto Kahn, a German-Jewish partner in the great investment banking house of Kuhn, Loeb and a protégé of E.H. Harriman, all of whom Morgan disliked, and run by an actor turned impresario named Heinrich Conried.

In the traditions of the era, one performance a year – at double prices – was devoted to a benefit for the general manager, and the opening night of Salome was Conried's benefit. It was a scandal from day one: the libretto, after all, is a play by Oscar Wilde that didn't suit the Victorian sensibilities of New York society. Salome is a short opera, usually in those days preceded by a curtain raiser. And for this occasion, Conried's curtain raiser was a gala with individual scenes and arias by the company's biggest stars.

To help build interest and make sure all tickets were sold, Conried staged a public dress rehearsal for a thousand invited guests on the previous Sunday, right after church. The house was packed with people Morgan knew and everybody was stunned by the lascivious performance. Critic Henry Krehbiel of the New York Tribune had expressed a "conscience stung into righteous fury by the moral stench with which Salome fills the nostrils of humanity."

But Morgan could not order the cancellation of subsequent performances; the contract with the producing company gave the Real Estate Company no power over repertory. Conried and Kahn had guaranteed Strauss and the soloists fees for a number of performances. Morgan offered to pay any losses the company incurred canceling Salome. Kahn, who had his own reasons to get rid of Conried and did so the next year, thanked Morgan for his offer and swallowed the costs. When he formed a new company to take over Conried's lease, he agreed to a clause permitting the real-estate board to cancel performances if its members had "just and valid cause" to find a production "seriously detrimental to the artistic interests of the Metropolitan Opera."

This is the Morgan whom Strouse presents: He gets his way, and he'll get his way next time, too. But here is the point Strouse does not fully exploit – he was fair; he leaves something on the table for the other guy.

Morgan dominated his world because he had the weight of money, and because he was enormously intelligent and saw the numbers before other people knew where to look for them. But also because he structured his deals to give a little something for everybody. No small part of Morgan's long-running success was due to the fact that he rarely gave the people he did business reason to regret the transactions. M

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If you've been residing in Burkina Faso for the last few months, you may not know that a seriously heavy-duty economist has been appointed Secretary of the Treasury. And even if you're the sort who keeps up with the news, you may not know just how good an economist Larry Summers is. Indeed, for sheer productivity and versatility, he has few peers in the history of the profession. John Maynard Keynes comes to mind.

That said, we thought you'd like to see a sampling of what Summers has had to say about the world in recent years. It may not sound like rocket-science – but, then, the man has been a Government employee since 1992. The research is courtesy of Trans-Atlantic Futures, a Washington/Frankfurt/Brussels-based economic advisory group.

ON ENOUGH IS ENOUGH

"The United States basically accepted protection abroad as the price of post-war recovery. Now that these countries have caught up to our level of prosperity, it is time for them to catch up to our level of openness."

ON AMERICAN BUSINESS' STAKE IN ASIA

"Even excluding Japan, more than 75 million Asian households will have attained middle-class wealth by the year 2000, demanding pharmaceuticals, communications, entertainment, financial services – the very things we in the United States do best."

ON WHY ASIA COLLAPSED SO QUICKLY

"Global capital markets pose the same kind of problems that jet planes do. They are faster, more comfortable, and they get you where you are going better. But the crashes are much more spectacular."

ON WORDPLAY

"Economists should maintain a strong, but rebuttable presumption in favor of all lateral reductions in trade barriers – whether they be multi-, uni-, bi-, tri-, or pluri-lateral."

ON SHOOTING THE MESSENGER

"Blaming speculators as a response to financial crisis goes back at least to the Greeks. It's almost always the wrong response."

ON PRETENDING TO BE THE SORT OF TOUGH GUY CONGRESS LIKES

"Now is the time to strike. We must strengthen our foothold in Asia to insure that no nation overtakes us."

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Kosovo 1999

ON NATO EXPANSION INTO CENTRAL EUROPE

"It was wrong to allow Stalin to shape the European landscape of the 20th century. It would be even more wrong to let him shape the landscape of the 21st century."

ON CONJURING THE BRIGHT SIDE TO THE WEAK YEN

"Americans do not need currency-induced adrenaline in order to compete"

ON WHY HOPE SEEMS TO SPRING ETERNAL AMONG RUSSIA-WATCHERS

"In politics, as in poetry, it is sometimes true that it is darkest before dawn."

ON MAKING LEMONADE OUT OF LEMONS

"In this age of electronic money, investors are no longer seduced by a financial 'dance of a thousand veils.' Only hard and accurate information on reserves, current accounts and fiscal and monetary conditions will keep capital from fleeing precipitously at the first sign of trouble."

ON WHY THE EURO REALLY IS GOOD FOR YOU AND ME

"Going forward with it will be very important so that Europeans recognize that no nation or region can devalue its way to prosperity."

ON WHY THERE WILL BE NO GAIN WITHOUT PAIN IN POST-CRISIS ASIA

"Start with the idea that you can't repeal the laws of economics, even if they are inconvenient."

AP/WIDE WORLD PHOTO (2)

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BY ROSS DEVOL

Technological innovation is powering the Great American Prosperity Machine, sustaining America's preeminence in industries ranging from pharmaceuticals to entertainment to software – or at least that it has been the assumption in recent years. Now, economists are not only finding the evidence that technology really is translating into higher productivity, but also discovering how it is driving success in local economies.

Perhaps the best indicator of the new focus on regionalism's ascendance is that policy makers from Jerusalem to Kuala Lumpur are busy trying to clone Silicon Valley. Geographic clustering is becoming central to the creation and understanding of what economists call "comparative advantage" in trade in an Information Age economy.

Since the late 1980's, there has been a resurgence of interest in the "new economic geography," which provides the foundation for analyzing specialized economic activity within regions. Clustering results from businesses and workers seeking out others engaged in related activities. Increasing returns to scale – as in, "the more that's made, the cheaper it is to make" – lead to competitive advantages. The usual suspects underlying these increasing returns include access to specialized labor skills, supplier networks and technology spillovers.

Such externalities play a particularly important role in the case of high-tech industries. The initial presence of one research facility may lead to others being established nearby and, ultimately, to the clustering of businesses. Countering the centripetal effects are many forces – land and water scarcity, traffic congestion, air pollution – that favor economic dispersion. As economic activity concentrates, rents are bid up, eroding the advantage of the region. With mounting barriers to the entry of new companies, a new competing cluster may form somewhere else. The intricate ebb and flow goes on.

ROSS DEVOL is director of regional studies at The Milken Institute.

CLUSTERING IN HIGH-TECH INDUSTRIES

Of course, the relative importance of the various "push-pull" factors that influence clustering vary by industry and epoch. Historical accidents as random as Oppenheimer's love of the Los Alamos mountains or the pull of a local Congressman sometimes provide a critical advantage.

Many of the factors that attract high-tech companies are the same ones that attract traditional industries: taxes, wage rates, rents, energy costs and the like. Others seem more important to high-tech companies, notably access to a trained workforce, proximity to

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research facilities, a network of suppliers, local venture capital and so forth. Mature high-tech manufacturers place a higher value on the traditional cost-of-doing business measures than service companies.

TECHNOLOGY'S IMPORTANCE IN METRO GROWTH PATTERNS

Success in creating a high-tech cluster is now the distinguishing determinant of metropolitan vitality. The regional studies group at The Milken Institute measured the statistical links between high-tech and local economic growth using data covering 315 metropolitan areas. We chose to focus on the 1990's because this is the period in which high-tech's muscle in the national economy became so obvious.

In our statistical model, we "explain" the relative-output growth index of a locality by 1) the relative growth of high-tech output, and 2) an index of concentration of high-tech activity in 1990. As the graph suggests, two-thirds of the total-output growth differences among metros could be explained by these two factors alone.

The dynamics of high-tech clustering follow a fairly predictable pattern. As clusters develop, a supplier network is formed. The demand for locally produced professional services with specialized knowledge – for example, legal services – expands. These highly compensated occupations further stimulate local economies. Another important channel through which high-tech industries promote growth locally is the in-migration of knowledge workers and their families. These effects can lead to a virtuous circle of positive feedbacks, with advantage leading to greater advantage.

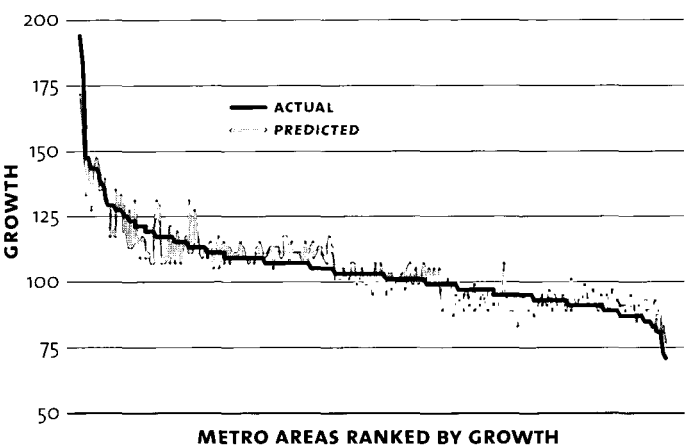
HIGH-TECHNOLOGY SPATIAL CONCENTRATION

A straightforward approach to measuring high-tech spatial concentration (see Charticle, page 12) seems the most appropriate. The dominance of Silicon Valley (San Jose metro) as a high-tech industry center is well documented, but our composite index of 23.7 is more than three times the size of the second-ranked metro. As a "tech-pole," the gravitational pull of the San Jose metro area is unparalleled. Silicon Valley created the personal-computer industry and is on the cutting edge of electronic networking.

Dallas's position, second on the index, might be surprising, but with a diversified high-tech base. GTE's global headquarters are

METRO GROWTH EXPLAINED BY HIGH TECHNOLOGY 1990-98

AVERAGE METRO GROWTH = 100



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in Dallas, while Nortel, Ericsson, Fujitsu and Alcatel have United States headquarters there. Austin is thought by many to be the center of Texas's electronic components industry, but Dallas produces 20 percent more and employs 4,200 more people.

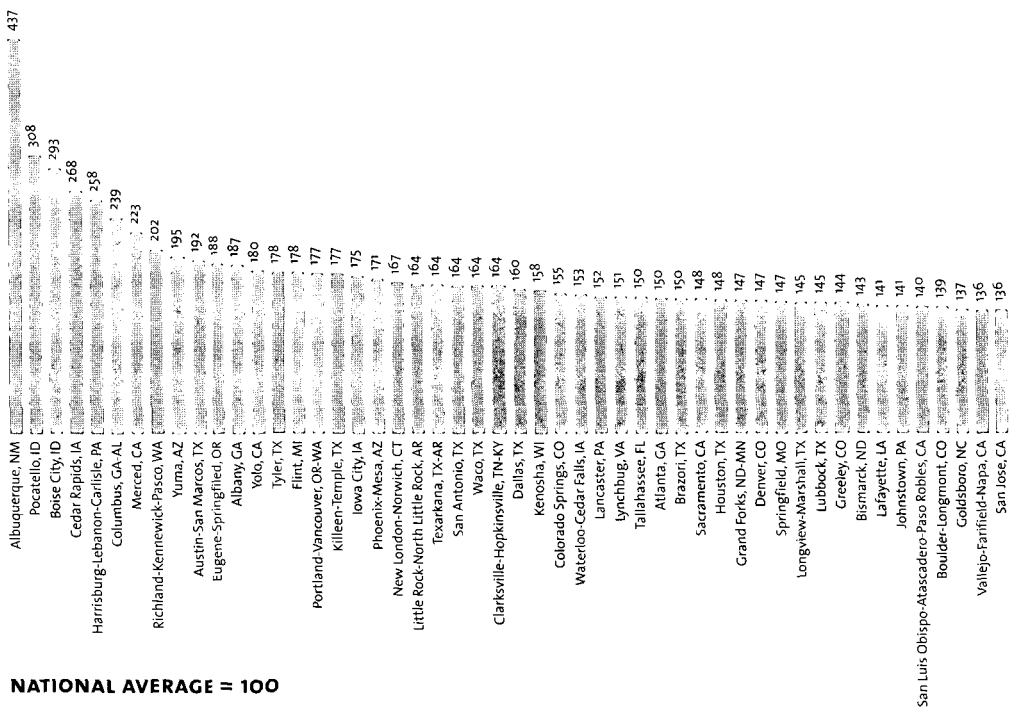
Despite the loss of military-related high-tech companies in the early 1990's, Los Angeles ranks third on the index. The ranking is somewhat inflated, perhaps, by the inclusion of non-high-tech portions of motion picture production and services. Even if the entire entertainment industry were excluded, though, Los Angeles would rank seventh.

Boston places fourth on the list, with an above-average concentration in 11 high-tech industries. Although the joint impact of military downsizing and heavy dependence on the lagging mainframe computer industry has been sizable, it is enjoying renewed vigor due to its Internet-related prowess.

Aircraft is still a major industry in Seattle, but software's rapid growth has made computer and data processing services a vital part of the economy. Microsoft, of course, is the nucleus of the Seattle software cluster.

Thereafter, the rankings are full of surprises. On a composite ranking of high-tech services, Washington, D.C. places first in the country, and sixth overall in high-tech. Albuquerque's ranking derives from its success in attracting electronic component manufacturers. Chicago is an important center of communications equipment, courtesy of Motorola. The windy city also has an above

METRO HIGH-TECH GROWTH
THE TOP 50 1990-1999



NATIONAL AVERAGE = 100

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average concentration in pharmaceuticals, and research and testing services. New York's ninth rank is in due in part to its major presence in telecom.

Atlanta is the undisputed high-tech capital of the Southeast, with a foothold in telecommunication services, computers and data processing services. Oakland's fourteenth position places it just behind Orange County, Calif., – a fact that may surprise those accustomed to thinking of it as an aging seaport and home to a struggling underclass. San Diego, with its diversified high-tech economy, ranks seventeenth. Raleigh-Durham-Chapel Hill, Denver, Austin, San Francisco, Houston and Boise round out the top 25.

HIGH-TECHNOLOGY SPATIAL GROWTH

Spatial concentration is important, but it does not guarantee continuing high-tech growth. And here, with smaller clusters in the midst of rapid expansion, the rankings are quite different. Albuquerque is at the top, recording a compound annual growth rate of 12.7 percent in high-tech output in the 1990's. Pocatello and Boise home to Hewlett-Packard's laser-jet printer division as well as to Micron Technologies, are second and third respectively. Cedar Rapids and Harrisburg, rapidly growing centers of electronic component manufacture, are fourth and fifth. Columbus, Ga., ranks sixth due to computer and data processing services. Merced, Calif., recorded strong growth in pharmaceuticals, albeit on a very small high-tech base. The Richland, Wash., metro area witnessed increases in engineering and architectural services. Austin, a center of computer and electronics production, ranked tenth.

Flint, Mich., ranks high in the 1990's due to strong growth in data processing services, while Portland. Ore., is becoming a center of semiconductor chip and wafer production. Houston was built on energy, but its future will have a high-tech component.

CONCENTRATION VS. DISPERSION: WHO'S WINNING?

There is evidence that high-tech manufacturing is becoming less spatially concentrated, but that high-tech services exhibit strong agglomeration. And even though manufacturing is dispersing to peripheral regions, it remains geographically concentrated.

Most of the metros that led in high-tech concentration 20 years ago are now slipping. Cities experiencing the fastest growth in high-tech industries in the 1990's largely consist of small to medium-sized localities that have attracted high-tech manufacturing. Most of the metros (38 out of the top 50 in high-tech growth) are in the South or West, and they rank high on most measures of cost-of-doing business, cost of living and on that elusive concept, the quality-of-life. Their sustained success depends upon the degree to which they can contain congestion and production costs.

High-tech services are also growing the fastest in small to medium-sized metros that have developed a critical mass. In contrast to manufacturing, however, the overall concentration of high-tech services is rising. Services apparently benefit more from geographic proximity than manufacturing. Computer and data processing services are becoming more spatially concentrated – software and Internet-related activities especially so.

Despite the evidence of dispersion in high-tech manufacturing, it is remarkable how concentrated it remains. Agglomeration forces in manufacturing are very durable and can only be thwarted by high congestion-related costs. A combination of high costs and obsolete technology seems to be a prerequisite to decline. M

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INSTITUTE NEWS

SEMINARS

Two of Asia's most important economies – those of China and South Korea – were the subjects of seminars this spring sponsored by The Milken Institute.

• **China in Transition: Social and Economic Challenges.** Speakers at the April 29 seminar at the Institute's conference center in Santa Monica included Barry Naughton of the University of California (San Diego), Vaclav Smil of the University of Manitoba and Anthony Saich of the Ford Foundation in Beijing and Harvard's Kennedy School of Government. The seminar was co-sponsored by the Asia Society and the U.SC.-U.C.L.A. Center for East Asian Studies.

• On May 24, See-Young Lee, South Korea's ambassador to the United Nations, discussed current diplomatic initiatives with North Korea that may represent the Korean peninsula's last opportunity for an enduring peace. Also speaking at the seminar at the Biltmore Hotel: Hilton Root, a senior fellow at the Milken Institute, and Ci-Wook Shin, a sociologist at U.C.L.A. The event was co-sponsored by the Asia Society and the U.C.L.A. Center for Korean Studies.

Technology was the focus of two other recent seminars at The Milken Institute.

• **Corporate Debt and the Technology Shock.** The speakers at the seminar on May 24 were David Goldman, global credit strategist, and Bob Kricheff, managing director, of Credit Suisse First Boston.

• **Lessons from Lexecon: Battling Back Against Frivolous Securities Lawsuits.** The meeting, on June 14, was co-sponsored by the law firm of Mayer, Brown & Platt. Four of the firm's partners, former U.S. Secretary of Commerce Mickey Kantor, Mark H. Gitenstein, Alan N. Salpeter and Philip R. Recht, spoke.

FORBES – BEST CITIES

The May 31 issue of *Forbes* ranked the 162 best places in the United States to look for a new job or to start a business. Information about opportunities in high technology came from research by Ross DeVol, Director of the Institute's Regional and Demographic Studies group, and his staff. The work is part of a larger Institute project on the economic impact of high technology on U.S. metropolitan areas, scheduled for release this summer.

NEW STAFF: MICHAEL HARRINGTON

Michael Harrington has joined the Institute as a research associate. Harrington was most recently a teaching fellow in the U.C.L.A. Department of Political Science. He received his M.B.A. in finance and his Ph.D. in political science from U.C.L.A.

MILKEN INSTITUTE FORUM

The Institute has launched a new speaking series that brings together specialists in business and finance to discuss current economic issues at its conference center in Santa Monica. Kenneth C. Green, founder and director of The Campus Computer Project, a widely praised source of information on technology issues affecting higher education,

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Publications

Studies released by The Milken Institute last quarter include:

• *The New Korea: Crisis Brings Opportunity*, by Hilton Root, offers an in-depth contemporary look at economic, political and social institutions in South Korea. Root predicts that South Korea will backslide from short-term economic progress unless fundamental changes, brokered by the International Monetary Fund and the World Bank, are made in the country's financial structure, labor organizations and major corporations.

• *Mainstreaming Minority Business: Financing Domestic Emerging Markets*, by Glenn Yago and Michael Harrington calls for an overhaul of government regulation and the creation of a secondary capital market to serve America's rapidly growing minority business community. The U.S. Department of Commerce's Minority Business Development Agency commissioned the study.

• *Capital Access Index: Deconstructing Global Financial Architecture*, by Glenn Yago, Lalita Ramesh, Dan Brumbaugh and James Barth, is the fourth in a series of quarterly reports measuring the efficiency of national capital markets – and the first to compare countries across regions.

Publications can be ordered through the Institute's web site, www.milken-inst.org, or by e-mail, info@milken-inst.org, phone, 310-998-2600, or snail mail, The Milken Institute, Publications Department, 1250 Fourth Street, Santa Monica, California 90401.

inaugurated the series with a talk, entitled Icons of the Internet Economy, on June 30. Graham W. Allen, a member of the British Parliament, will speak on Sept. 13 on The Role of Technology in European Politics.

These afternoon events are free, but reservations are requested (call 310-998-2605). Check the Institute's web site calendar (www.milken-inst.org).

COUNCIL ON FOREIGN RELATIONS WORKING GROUP

Glenn Yago, Director of Capital Studies, and Peter Passell, Editor of *The Milken Institute Review*, are serving on a Council on Foreign Relations Working Group on Development, Trade and International Finance, which will develop proposals for reforming international capital markets that is funded by the Ford Foundation. Walter Mead, Senior Fellow at the Council, leads the group. At the first meeting on June 10, Yago presented a paper on international financial architecture that will serve as the basis for the group's initial discussions.

CALIFORNIA MINORITY-BUSINESS PROJECT

The Federal Reserve Bank of San Francisco has joined a growing list of California government agencies and financial institutions working to give businesses owned by minority groups easier access to capital – a project inspired by The Milken Institute's report, Mainstreaming Minority Business.

The bank scheduled a day-long meeting on July 7 to discuss the "Economic Development Loan Securitization in California" project. Among those attending were California State Treasurer Phil Angelides, state Senator Richard Alarcon, state Insurance Commissioner Charles Quackenbush, and a host of financial leaders representing various agencies and private lenders. M

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BY 2015, 45% OF OUR GDP WILL DERIVE FROM THIS VIRTUAL ECONOMY AND YOU'VE GOT A CHANCE TO GET IN ON THE GROUND FLOOR!
I'M SOLD!
COUNT ME IN!
SO, LINE UP THOSE DUMP TRUCKS, PILE ON THE DOUGH AND GET READY TO GET GROUND INTO THE FLOOR!
(DID I SAY THAT RIGHT?)

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Robert Sobel, a long-time friend of The Milken Institute, died in June after a long illness. We could think of no better tribute than reporter Diana Henriques' splendid obituary in The New York Times *on June 4.*

ROBERT SOBEL, a prolific historian of American business life whose topics ranged from the economic philosophy of President Calvin Coolidge to the influence of junk bond financier Michael Milken, died on Wednesday at his home in Long Beach, NY. He was 68. The cause of death was brain cancer, said a spokesman for Hofstra University, where Prof. Sobel taught for 43 years.

Prof. Sobel's first book, *The Origins of Intervention*, was published in 1961. His latest is a study of business blunders called *When Giants Stumble* just released by Prentice-Hall.

Besides teaching, Prof. Sobel was the author, co-author or editor of more than 50 books. He never bristled when scholars dismissed him as a "populizer," said his friend George David Smith of New York University. "Quite the contrary – he saw that as his mission in life."

Still, that did not stop Prof. Sobel from taking a gentle revenge on his ivory-tower critics in 1973 with the publication of *For Want of a Nail*, his mock textbook recounting the history of North America had General Burgoyne won the Revolutionary War battle at Saratoga.

But his dominant passion was Wall Street, a metaphysical neighborhood that had fascinated him since childhood. "It is as though you are walking though an historical theme park, with this engaging man at your side pointing out the sights," wrote Andrew Tobias, the author and investment writer.

Friends said he considered *The Life and Times of Dillon Read* to be his finest book, but he produced other notable profiles, including *Dangerous Dreamers: The Financial Innovators from Charles Merrill to Michael Milken* (John Wiley, 1993). "Specialized scholars could learn a lot from him – and you are talking to one who did," acknowledged Richard Sylla, a historian at N.Y.U.

Unlike most academic writers, he was happy to ghostwrite business books. And he collaborated on several that never reached a public audience, including the memoirs of Joseph Cullman, the legendary leader of Philip Morris. Prof. Sobel was clearly less enthralled with the corporate world, but that only slightly affected his output. His corporate histories included studies of RCA, ITT, the Penn Central Railroad, the automotive industry, the tobacco industry, the Trammel Crow construction empire and IBM.

Robert Sobel was born in the Bronx, the son of a draftsman who drew promotional posters for the Loews movie theaters. He was educated at the City College of New York and earned his master's degree in history at New York University in 1952 before enlisting in the armed forces. He later told family members that he had hoped to be in military intelligence, but was turned down because of unfounded suspicions that he was related to Morton Sobel, a figure in the Rosenberg spy case.

After earning is Ph.D. in 1957 from N.Y.U., he joined the faculty at Hofstra, where he remained for four decades. A memorial service will be held for Prof. Sobel in September at the Hofstra campus.

Friends say that teaching history did not satisfy him as much as writing history – or, indeed, writing anything. Besides producing books, articles and the like, he was a columnist for *Newsday* from 1972 to 1988, and later, a contributing editor to *Barron's* magazine.

Prof. Sobel is survived by his wife, Carol Ritter Sobel of Long Beach; his mother, Blanche Sobel of Riverdale; a brother Alan Sobel of Brooklyn; two children, Barbara Sobel of Queens and David Sobel of Alexandria, LA, and two grandchildren.

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